Financing Sustainable Development: Addressing Vulnerabilities

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Financing Sustainable Development: Addressing Vulnerabilities

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FERDI
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Fondation pour les études et recherches sur le développement international

The Fondation pour les études et recherches sur le développement international (Ferdi) was created in 2003 at the initiative of CERDI (Centre d'études et de recherches sur le développement international, University of Auvergne and CNRS). Its mission is to promote a fuller understanding of international economic development and the factors that influence it.

With its network of over 150 experts, Ferdi supports research activities that use the most directly relevant instruments and methods to study development and seeks to strengthen the potential of the French-speaking world in this area.

Ferdi endeavours to promote the contribution of French and European work to the international debate on major development issues, in particular on how Southern and Northern economic policies can best assist development by broadening the capacity for individual choice and by developing equality of opportunity among nations. Ferdi wishes to contribute to improving these policies and providing information for companies whose business depends on world markets and their outlook.

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List of Abbreviations

AAA	Accra Agenda for Action
ADB	African Development Bank
ADF	African Development Fund
AFD	Agence Française de Développement
AfDB	African Development Bank Group
AIIB	Asian Infrastructure Investment Bank
AMC	advanced market commitment
BAU	business as usual
BEPS	Base Erosion and Profit Sharing project
BRAC	Bangladesh Rural Advancement Committee
BRICS	Brazil, Russia, India, China and South Africa
BRIICS	Brazil, Russia, India, Indonesia, China and South Africa
CAD	China-Africa Development (Fund)
CAEMU	Central African Economic and Monetary Union
CAT	cap-and-trade
CB	crediting baseline
CBDRRC	common but differentiated responsibilities and respective capabilities
CCMA	climate change mitigation and adaptation
CDB	China Development Bank
CDM	Clean Development Mechanism
CF	climate finance
CGIAR	Consultative Group on International Agricultural Research
CIF	Climate Investment Fund
CIFOR	Center for International Forestry Research
CIT	corporate income tax
CITES	Convention for the protection of Endangered Species of Flora and Fauna
COE	centre of excellence
COMESA	Common Market for Eastern and Southern Africa
COW	Committee of the Whole (of the UN General Assembly)
CPA	Country Programmable Aid
CPI	Climate Policy Initiative
CPIA	Country Policy and Institutional Assessment
CRA	contingency reserve arrangement
CRS	OECD Creditor Reporting System
CSO	civil society organization
CSR	corporate social responsibility
CTCN	Climate Technology Centre and Network
DAC	OEDC Development Assistance Committee

DAH	development assistance for health
DFI	development finance institution
DIB	development impact bond
DSF	World Bank/IMF Debt Sustainability Framework
DTA	double taxation agreement
DWG	Development Working Group
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EITI	Extractive Industries Transparency Initiative
ESTIF	Endangered Species Technology & Innovation Fund
ETF	exchange trade fund
ETS	Emissions Trading System
EVPA	European Venture Philanthropy Association
FDI	foreign direct investment
FfD	financing for development
FTT	financial transation tax
Gavi	Global Alliance for Vaccines and Immunization
GCF	Green Climate Fund
GDN	Global Development Network
GGG	Global Governance Group (of UN member states)
GIIN	Global Impact Investing Network
GDP	gross domestic product
GEF	Global Environment Facility
GNI	gross national income
GNP	gross national product
GPE	Global Partnership for Education
GPEDC	Global Partnership for Effective Development Cooperation
GPG	global public good
HIPC	Heavily Indebted Poor Countries Initiative
ICESDF	Intergovernmental Committee of Experts on Sustainable Development Financing
ICF	international climate finance
IDA	International Development Association
IEA	International Energy Agency
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFF	Innovative Finance Foundation
IFFIm	International Facility for Immunization
IFI	international finance institutions
IMF	International Monetary Fund
INRI	indicator of need for regional integration
IPCF	international public climate finance
IPF4SD	International Public Finance for Sustainable Development
IREA	International Renewable Energy Agency

ITCD	International Centre for Taxation and Development
JBIC	Japan Bank for International Cooperation
JICA	Japan International Cooperation Agency
LDC	least developed country
LFA	logical framework approach
LIC	low-income country
LMIC	lower middle-income country
MDB	multilateral development bank
MDG	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MENA	Middle East and North Africa
MfDR	managing for development results
MIGA	Multilateral Investment Guarantee Agency
MIS	management information system
MoI	means of implementation
MOU	memorandum of understanding
MPP	Medicine Patent Pool
MRT	mining rent tax
NABARD	National Bank for Agriculture and Rural Development
NAM	Non-Aligned Movement
NCD	non-communicable disease
NEPAD	New Partnership for Africa's Development
NGO	non-governmental organization
NIEO	New International Economic Order
NSIA	Nigeria Sovereign Investment Authority
OBA	output-based aid
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
OOF	other official funds
OPIC	Overseas Private Investment Corporation
OWG	Open Working Group
PBR	payment by results
PCI	per capita income
PEPFAR	US President's Emergency Plan for AIDS Relief
PES	payments for ecosystem/environmental services
PforR	Program for Results
PIPCF	pooled international public climate finance
PIDG	Partnership for Infrastructure Development
PRI	programme-related investment
RBA	results-based aid
RBF	results-based financing
RCA	revealed comparative advantage
REDD	Reducing Emissions from Deforestation and Forest Degredation

REN21	Renewable Energy Policy Network for the 21st Century
RFI	resource-financed infrastructure
RL	reference level
ROSCA	Rotating Savings and Credit Association
RoW	rest of world
SADC	South African Development Community
SAP	Structural Adjustment Program
SDGs	Sustainable Development Goals
SDR	Special Drawing Right
SEZ	special economic zone
SE4ALL	Sustainable Energy for All initiative
SIB	social impact bond
SME	small and medium-sized enterprise
SRI	socially responsible investor
SSA	sub-Saharan Africa
SSDC	South-South development cooperation
SSC	South-South cooperation
SWF	sovereign wealth fund
TFP	total factor productivity or Trade Finance Programme
TOSD	Total Official support for Sustainable Development
TrC	triangular cooperation
TRIPS	trade-related aspects of intellectual property rights
UMIC	upper middle-income country
UN	United Nations
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
UNFCCC	United Nations Framework Convention on Climate Change
UNIDO	United Nations Industrial Organization
WAEMU	West African Economic and Monetary Union
WMO	World Meteorological Organization
WP-STAT	DAC Working Party on Development Finance Statistics
WTO	Word Trade Organization

Introduction

Using Finance to Address Vulnerability and Make Development Sustainable: Issues and Contributions

Patrick Guillaumont and Matthieu Boussichas

This introductory chapter first presents the major issues that the financing of sustainable development must address and outlines the general orientation of the book – designing development financing that is sustainable and addresses the various types of vulnerabilities faced by poor countries. We suggest elements of a response to some of the major issues, some of which are covered in the subsequent chapters.

In a second part to this introduction, we summarise the answers given in the various chapters to the questions raised in the first part. This summary aims to be faithful to those answers without expressing any reservations, even if they are not necessarily consistent with each other, in order not to weaken the force of the proposals that emanate from them. All of the chapters share the common aim of making development financing sustainable and addressing countries' vulnerabilities.

1. Issues to be addressed by sustainable development finance

In the first part of this introductory chapter, we follow the original book outline and discuss, according to this plan, a small range of issues that give the book its content around the general theme, namely, the promotion of sustainability by tackling vulnerabilities. Once we have recalled the purpose and spirit of the book, we first consider the major cross-sectional issues, and then review the three types of problems that must be answered and that correspond to the three main dimensions of sustainability – economic, social and environmental (mainly climate-related).

A book that relies on focused issues

International events, their sequence and its meaning

This book on financing for development is published during a year that is rich in important international events for development. The final event of the year, COP21, will take place in Paris in December and is crucial to the climate negotiations. It will be preceded by the adoption of the new Sustainable Development Goals (SDGs) by the General Assembly of the United Nations in New York in September, and by the UN's International Conference on Financing

for Development in Addis Ababa in July. What can we infer from this timeline? While the previous International Conference on Financing for Development, which resulted in the 'Monterrey Consensus', took place in 2002, two years after the adoption of the Millennium Development Goals (and was itself followed by their actualisation in Doha in 2008), this time the issue of financing for development will be addressed before the adoption of the SDGs. This sequence seems to imply that the intention is to adapt the goals the financing, which will not probably be the case. Nevertheless, the prospects of funding that result from the Addis Ababa conference will be integrated somehow into the post-2015 Development Agenda to be adopted in September. It is with this perspective in mind that this book has been designed. Its purpose is to explore how development finance can contribute to the achievement of the post-2015 Agenda.

Varying and independent views

To this end, the book gathers together the views of independent experts. It does not seek a consensus in which each author supports all the formulated proposals. The points of view are the personal responsibility of the authors, who all have been selected for their expertise on the topic they address, whether scientific or operational.[1] The 45 authors are from 15 different countries, the majority of which are European, though all other parts of the world (Africa, Latin America, China, the United States, India, Japan, etc.) are also represented. Several chapters are jointly written by two authors, one from the North and the other from the South.

Common attention given to sustainability and vulnerability

The diversity of the contributions to this book is consistent with its general orientation, which is intended to match the post-2015 Agenda, and is the result of the following diagnosis. It is now widely agreed that development sustainability can be expressed along three easily distinguishable, but closely related dimensions – economic, social and environmental. Sustainable development is threatened by various forms of vulnerability, which find their source in these three dimensions. To promote sustainable development, funding should therefore tackle economic vulnerability, social and political vulnerability, and environmental vulnerability (in particular, vulnerability to climate change). If vulnerability means the risk of being (permanently) affected by exogenous shocks – whether external or natural – it can be tackled either by shock mitigation or by adaptation to shocks. This distinction, now commonly made with regards to climate change, applies to all sources of vulnerability. To some finer degree, it is convenient and now usual to distinguish three components of vulnerability – the magnitude of the impact of expected shocks, structural exposure to these shocks, and adaptation capacity or resilience. Mitigation covers the first two components, while adaptation concerns the third.

1 Only a small number of the authors (one fifth) are currently working in international institutions.

Cross-sectional issues

What's new and what isn't new: When is finance innovative?

There is a certain misconception that the new agenda for development, and the new mode of financing for development that is supposed to support it, are entirely new. However, the novelty lies mainly in the proportions attributed to each mode of financing and their evolution, and also sometimes in the semantics used to describe them. If innovation in the field were to be limited to so-called 'innovative financing for development' to its current extent, it would be insufficient to really constitute the emergence of a new financing for development. More than a half century ago, some had already proposed the adoption of a 'cosmic tax' for development (Moussa, 1958), dependent on the income of the developed countries, which was more ambitious but certainly less realistic than the funding presented today as innovative.

The innovative nature of financing may in fact refer to either its source or its terms. If philanthropic sources are sometimes classified as innovative, this is essentially due to their greater volume and diversity; the principle itself is not innovative. More clearly considered innovative are the new levy taxes or para-fiscal bases that have been introduced (e.g. airfares) or that have been proposed (e.g. financial transactions or consumption of drugs). The difficulty of using new tax bases lies in finding ones that do not generate distortions and inefficiency, and also in maintaining the link between the tax base and the purpose to which the tax receipt was originally supposed to be directed, as shown in the case of the tax on airline tickets.[2]

Innovations in funding modalities are probably more promising and, even though they are often an old practice, are likely to expand. This is the case for the 'counter-cyclical loans' of the Agence française de développement (AFD), examined below in more detail. One can see throughout these various cases an attempt to respond to a problem of vulnerability.

Finally, should we consider all the financing that corresponds to the new vision of development that the SDGs are supposed to reflect as "innovative"? This would imply that the SDGs express a fundamentally new vision and that all of the corresponding funding is part of this vision, forged during the long process of the preparation of the goals. But the qualifiers 'sustainable', 'humane' and 'inclusive' that are used today to describe development in fact identify the substance of development, which is perhaps often forgetten. The development economics textbooks of half a century ago differentiated between growth and development by stating that development corresponds to economic growth that is sustained and distributed among all segments of the population. From the beginning, development was designed as sustainable and inclusive, but so-called 'development finance' has probably not taken these two qualifiers of development sufficiently into account.

2 We proposed, before the Monterrey Conference, a voluntary levy on the purchase of drugs in pharmacies, based on the idea of a provision for solidarity on the part of those in rich countries who have access to medicines with those in poor countries who have no access (Guillaumont, 2002).

Indeed, the concept of sustainability has since been enriched significantly with the construction of its three dimensions – economic, social and environmental – and financing for development should take each of these into account.

Universalism and differentiation considered more compatible

Two views that appeared be opposing at the beginning of the process of preparation of the post-2015 Development Agenda have finally have been reconciled. The Agenda is universal in that it concerns all the countries of the world and not just the developing countries, even though it appears primarily to concern those. It is universal also in that it concerns all the citizens of the world – the poor must not remain so, wherever they are ('nobody left behind'). The differentiation between groups of countries according to their specificity was, at the beginning of the process, perceived to some extent as altering the principle of universality, but over the months the need for differentiation was acknowledged. A major illustration of this is the attention paid to the category of the Least Developed Countries (LDCs), the only official UN category within the group of developing countries. There is only one reference to this category in the report of the High-Level Panel (United Nations, 2013a) and in the report of the Sustainable Development Solutions Network (SDSN (United Nations, 2013c),[3] there are five references to it in the report of the Secretary-General of the United Nations on the post-2015 Development Agenda (United Nations, 2013b), while in the report of the Open Working Group of the General Assembly on Sustainable Development (United Nations, 2014a) the word 'LDCs' appears 26 times, as it does in the report of the Intergovernmental Committee of Experts on Sustainable Development Financing (United Nations, 2014b).

The recognition of the specific needs of vulnerable countries, and in particular the LDCs, has progressed, thanks to a large extent to the power of persuasion of the Office of the High Level Representative for Least Developed Countries, Landlocked Developing Countries and Small Island Developing States (OHRLLS) and the echoing of this among policy-makers. At the same time, the intellectual coherence between the principles of universalism and differentiation has been well established. Ferdi has been able to promote this at various meetings at the United Nations (side events or interventions at the Open Working Group). All the poor of the earth deserve equal attention and, while the majority are in middle-income countries, low-income countries facing severe handicaps to growth – which are by definition the LDCs – generally have a higher proportion of poor who mostly have even lower chances of getting out of poverty. The definition of universal objectives cannot ignore the structural handicaps that characterise some countries and condition their progress towards these universal goals. It is logical and fair that the international community supports these countries in particular, even if they are not where the majority of the poor are to be found.

3 However, the 'vulnerable countries' are mentioned nine times.

Specificity of the LDCs: One or more poverty traps?
However, the proliferation of special situations would inevitably call into question the principle of universality. This is why it makes sense to focus as a priority on LDCs, specifically defined as poor countries that face structural handicaps which limit their opportunities for sustainable development. In other words, these are the countries that can be caught in a 'poverty trap' (Guillaumont, 2009a). As it is used in development economics, the concept of a poverty trap could be criticised if it were interpreted as a determinism, which it is not. It highlights a real risk faced by many countries. Two types of structural handicap, which are considered to some extent to be independent of countries' current will, are used in the identification of the LDCs by the United Nations: a low level of human capital in terms of education and health (assessed via the Human Assets Index, HAI); and a strong structural vulnerability (assessed via the Economic Vulnerability Index, EVI). As the level of human capital is fairly closely correlated to income per head, LDCs are often likened to poor and vulnerable countries. They are economically vulnerable according to the EVI index, which takes into account both the magnitude of external and natural shocks they repeatedly face (for example, changes in international commodity prices or droughts) and their exposure to these shocks (measured by the size of the country, its remoteness, the concentration of its exports, the structure of its production, etc.). But they are also vulnerable with regard to other indices relating to climate change or to political and social fragility. These are all arguments for offering particular support to LDCs (Guillaumont et al., 2015).

The issue of 'traps' in the development process has re-emerged in recent years in another context – a possible 'middle-income trap' that would block a country in its growth after it has passed the low-income threshold and has therefore escaped the poverty trap. The existence of a 'middle-income trap' could be an argument for specific support for lower-middle-income countries, alongside the fact that they include the majority of the world's poor. Related to this is the thesis of the 'missing middle', according to which the reduction of aid is not matched by an increase in tax revenues until a certain threshold of per capita income is reached. The middle-income trap hypothesis has been debated even more than the low-level trap, as has the missing middle hypothesis more recently. Beyond the theoretical and statistical controversy, the important point for the structure of financing within the new Agenda is that these concepts are based on assumptions and observations relating to the policies of states, while the concept of a trap that is at the heart of the categorisation of LDCs is based on a diagnosis of structural handicaps that are supposedly beyond a country's will, and thus justify specific support from the international community.

Eligibility and graduation issues: Criteria are more important than categories
When differentiation occurs across categories, there are inevitably problems of borders. The differentiation of funding according to groups of countries depends on the thresholds of the basis on which these groups are identified. This applies to groups of countries that are eligible for concessional windows of the MDBs, and to the LDC category as well. The issue of the conditions of 'graduation' then

arises with acuity. It was first discussed, and often still is, in the case of LDCs, which can be explained by two main reasons.

The first reason is that various trade and financial benefits are supposed to depend on belonging to the LDC category under a binary mode (e.g. a country either has or does not have access to 'everything but arms' of the European Union), raising the fears of graduation. The second reason is related to the very working of the category, which for 20 years after its creation in 1971 included no output mechanism. The graduation conditions were defined in 1991 in a spirit of extreme caution, but in a complex manner that amplified the fears and debates (Guilllaumont 2009a, Guillaumont and Drabo, 2014).

Over the last 15 years, the question of the graduation of LDCs has evolved in a way that offers lessons for other *ad hoc* categories set up by various institutions. In the first place, the countries proposed for graduation more often than not resisted it. In doing so, they received time extensions from the United Nations, within the framework of a 'smooth transition' strategy. An important, though not often noted development was the adoption of a resolution on smooth transition through which the General Assembly of the United Nations invited the development partners to use the criteria for the identification of LDCs (including the vulnerability criterion) as criteria for aid allocation. This invitation, which takes up a proposal repeatedly made by Ferdi and which has been implemented by the European Union, is evidence of the interest in considering criteria in addition to categories and, where appropriate, in preference to categories (Guillaumont 2011a, 2013; Guillaumont et al., 2013). If the LDCs are to be given preference in international policy, it would be due to their structural characteristics. If so, it is legitimate to grant benefits according to these characteristics (or the criteria that reflect them), and one can thus meet the aims of the category while avoiding the graduation discontinuity. This is obviously not possible, however, for binary policy measures.

Ambiguous and recurring doubts about absorptive capacity

Joining concerns about the drying-up of aid once a certain threshold of income is reached, doubts are repeatedly raised, through various arguments, about the capacity of low-income countries, in particular LDCs, to absorb large inflows of external assistance. Such doubts were already being expressed more than a half century ago, in reference to management difficulties and delays in implementation, but since this period have often regarded as false pretences to avoid increasing aid. The arguments have changed over the years, sometimes supported by cross-sectional econometric estimates (an early reversal of the curve representing the impact of aid on growth rate), sometimes by the risk of 'Dutch disease' (a loss of competitiveness due to appreciation of the real exchange rate), and sometimes by the risk of institutional decay. But all these arguments have been a matter of debate and none can really resist if we consider that absorptive capacity depends on the very modalities of aid, which prevents us from considering them as reasons for limiting the volume of aid, except in extreme cases (Guillaumont and Guillaumont Jeanneney, 2010).

The global governance of development financing

Two main institutional frameworks have over the past decade welcomed discussions on financing for development. One is that of the United Nations, whose conferences in Monterrey (2002) and Addis Ababa (2015), as well as the Doha mid-term conference in Doha (2008), constitute the major events. This framework has been strengthened by the Development Cooperation Forum, which has been organised every two years since 2008 at the initiative of the ECOSOC. The other framework is that of the OECD. Originally called the Forum on Aid Effectiveness, it met in Rome (2004), Paris (2006), Accra (2008) and Busan (2011), where it became the Global Partnership for Development, before meeting again in Mexico (2014). Before the Busan conference, the Paris and Accra Declarations had contributed specifically to adopting certain important principles for aid management, such as ownership and alignment. Since Busan, the objective has clearly been widened to the whole area of cooperation for development, and the Forum's members have tried to associate themselves with two large emerging countries, China and India, which only agreed with reservations to the Busan Declaration and limited their participation in the of Mexico conference. However, supported by UNDP, the new 'Global Partnership' is seeking a competence and legitimacy that would bring its role closer to that of the Development Cooperation Forum. The result is a clear need for coordination between these two frameworks, one which may be argued to be wider and more legitimate, while the other it is perhaps more operational.

Another problem that reveals this competition between institutions is the proliferation of international official meetings dealing with the financing of development,[4] involving what is probably an excessive number of senior officials from developing countries, despite the meetings being designed to ease their task.

As it is not necessarily the same people (from the North or South) who participate in all of the meetings, this may also result in a consistency problem, and certainly in a coordination problem (Guillaumont, 2011b). An example is provided again by the case of LDCs. Seven months after the adoption of the Istanbul Programme of Action (IPoA) at the end of the United Nations Conference on LDCs in May 2011, the final Declaration of the Busan conference made no mention of the LDCs, which brings to mind the title of the famous Alfred Hitchcock film, *The Lady Vanishes*; here, the LDCs vanished. In fact, while LDCs as a category are present in the meetings and records of the United Nations, they are not as present elsewhere, where more informal and variable groups of fragile states are preferred. It is no wonder, then, that the relationship between the structural economic vulnerability present in LDCs and the fragility of states is not better analysed and taken into account in policies (Guillaumont and Guillaumont Jeanneney, 2009).

4 Such as the UNCTAD XIII (in Doha in 2013) or the conferences of the United Nations, which are admittedly only decadal focusing on groups of specific countries (LDCs at Istanbul 2011, SIDS at Samoa 2014, LLDCs at Vienna, 2014), not to mention the meetings of the Bretton Woods Institutions.

Separate issues do not mean separate finance: Earmarked funds

Another general trend in financing for development is the proliferation of funds specific to a sector or a country – so-called 'arrow earmarked' funds set up within the multilateral system. The proliferation of sources of assistance to the same country, known as the fragmentation of aid, has indeed drawn much attention, as evidenced by a number of studies and statements, and we can assume that there is an optimal degree of fragmentation, noticeably depending on country size of the country.

Earmarked funds in the multilateral system, either in the form of a specialised multilateral institution, or within a multilateral institution (a so-called 'multi-bi'), raise a problem of greater magnitude, despite having received less attention. Are they a suitable financing instrument to promote sustainable development?

These funds were often created to meet sustainable development needs that were not being met by the existing system and they mainly address health needs (e.g. vaccinations with GAVI, a response to the challenge of AIDS with UNITAID), climate change (e.g.with the GEF) and acute country crises (the Central African crisis). They helped to obtain greater resources, were supposed to be more visibly effective and were spent more easily than through traditional channels, while having the advantages of multilateralism. Some seem to envisage financing for development after 2015 as a juxtaposition of sectoral funds (health, education, energy, infrastructure, etc.). But the number and volumes of these thematic funds – they represent around 800 funds at the World Bank and 60% of UNDP disbursements – raises three problems. The first is the appropriation by the recipient countries of policies designed by the leaders of thematic funds. The second, linked to the first, is the consistency of these strategies with the policies of the countries in the area and beyond. The third problem is related to the global geographical allocation of resources resulting from the disbursements from these funds.

Conditionality, results and vulnerability

The policy ownership issue has been discussed now for several decades, in particular in the context of ajustment policies and support. To avoid the shortcomings of the traditional conditionality, relying mainly on the use of policy instruments, a new kind of conditionality has been conceived, relying on results or performance and applied by the European Community to a small share of its budget support (Adam et al., 2004). While its application has remained limited, more and more interest was expressed for the result approach in aid management. For the enhancement of ownership in recipient coutries, the result or delivery approach seems quite relevant, but the results (obtained from a given support) may depend on exogenous circumstances, as well as initial conditions. It means that it should be supplemented by a consideration of possible exogenous events, and more generally of the countries' vulnerabilities.

Development finance for economic sustainability

Sustainability first implies sustainable economic growth. Financing for development must therefore allow countries to cope with the economic

vulnerabilities that may affect their development. The link between financing for development and sustainable growth covers many aspects, of which only a few are discussed here.

External assistance to dampen shocks

A great debate has been ongoing in the macroeconomic literature on aid effectiveness for 15 years. It has weakened complacent ideas according to which the effectiveness of aid depends essentially on the quality of policies and institutions in recipient countries. At the same time, it does appear that aid is more effective in the case of exogenous shocks because it allows amortisation (see a review of these cross-sectional econometric studies in Guillaumont and Wagner, 2014). In brief, shocks slow down growth and, as aid dampens shocks, its marginal effectiveness is stronger in vulnerable countries. Prioritising help for these countries, and in particular LDCs, is therefore legitimate not only for reasons of equity, as seen above, but also for the reason of effectiveness.

This effect, highlighted in various works (Chauvet and Guillaumont, 2001; Collier and Goderis, 2009), does not exclude the possibility of problems with aid instability, but the issue is not that aid in itself is unstable, but that it is sometimes unpredictable (hence the need for clear criteria for allocation), and in particular that this could have an overall destabilising impact. But more often, and in any case compared to the evolution of exports, aid has a stabilising impact, which explains why its marginal effectiveness is, on average, stronger in countries where exports are unstable (Guillaumont, 2006; Chauvet and Guillaumont, 2009).

Beyond volatility, continuity: Is there a gap in the evolution of development finance once aid declines?

Another aspect of aid effectiveness, and one that has been insufficiently explored, is the role it can play in the launch of economic growth in poor countries (through its impact on what it are known as ‘growth episodes’), and also on the duration of growth (Guillaumont and Wagner, 2012; 2014). This impact seems to be more significant in the case of exogenous shocks.

It is generally agreed that the importance of ODA in financing development declines with growth of income per head. But the speed of the decline and the threshold above which the aid could disappear are obviously matters of debate (as was made clear above in relation to the graduation of LDCs). The substantive issue is whether, above a certain threshold of income per capita, the growth is sufficiently sustainable, or ‘self-sustaining’, to no longer require external support on ODA terms. If countries are highly vulnerable to external or natural shocks, they may still need external support on preferential terms.

While the level of aid to GDP tends to decrease with increasing per capita income, the volume of tax revenues does not grow equivalently, at least up to a certain threshold. This was recently argued by Kharas and Rogerson (2014), who suggested the existence of a ‘missing middle’ that could justify the allocation of aid to lower-middle-income countries Behind the discussion of the strength of the relationship that underpins this thesis, the question is whether the lack of fiscal revenue in countries whose income per head is just above the low-income

threshold results from structural factors or political factors that are specific to those countries. Political factors are reversible and do not justify a specific effort from the international community. If the total volume of ODA is finite, whatever is taken by each country is at the expense of others.

The rationale for assistance beyond the low-income threshold seems stronger in the case of countries that are clearly vulnerable for exogenous reasons. This is what justifies the continuation of assistance to LDCs – the relatively numerous LDCs that are above the low income threshold, but are all still vulnerable.[5]

Which foreign-domestic linkages can make growth sustainable?

An important question raised by the previous debate concerns the likely linkage from concessional external financing to local (public and private) funding. Here, again, the impact of aid on domestic savings was the subject of an old debate (Guillaumont, 1985) in which radically opposing opinions joined to denounce the risk of eviction (crowding out) of savings by foreign aid. Two clear lessons emerged. One was that, even though there may be some substitution of aid to saving, the net effect of aid on investment remains positive. The other was that the relationship should be analysed in a dynamic manner, including the effect of additional investment on growth, and through it, on savings. Today's debate about the effects of aid and external funding on tax revenue lights the same way: even if there is some substitution of aid to tax revenues, the net effect on the financed expenditure is positive and the key is to consider it in dynamic framework through the effect on investment and growth (Guillaumont and Guillaumont Jeanneney, 2010). This leads to finding the uses of external funding that are most likely to lead to an increase in tax revenues, and in private investment as well. There is no doubt that technical assistance can still play a role here, as well as the development of the infrastructure for private investment. With this in mind, 'aid for trade' may have a significant impact (Cadot and de Melo, 2014).

Financing regional integration

One of the directions of external financing that can contribute effectively to the sustainability of economic growth is the support it can provide to regional integration. Regional integration is a powerful factor in reducing vulnerability, especially in smaller economies, through the various forms it can take (trade, money, coordination of budgetary policies, promotion of regional infrastructure, etc.). It creates an economic area that is more diversified than a narrow national space could be, reduces production costs and, above all, under its terms it requires integrated countries to carry out better economic policies and allows the sharing of risks between them.[6]

External support is essential to implement the integration measures, the benefits of which are often not perceived by the countries concerned to the same degree. So far, it does not appear that external financing has been sufficiently affected to this end (Guillaumont and Guillaumont Jeanneney, 2014). If there is

5 Kharas and Rogerson also recognise the merits of preference being given to LDCs for assistance.

6 See the proceedings of Ferdi's 10th anniversary conference, Guillaumont Jeanneney (2014), Hugon (2014) and Morrisson (2014).

one area where the concept of 'leverage' (a term that is often improperly used) can find a useful application, it is likely to be in the financing of integration.

A variety of means to cover the risks

There are a range of ways in which funding can cover the risks inherent in a development process. The emphasis in the previous sections has been on its assignments, but its financial conditions are obviously important. Debt sustainability is a major component of the sustainability of growth. Despite a mass of studies, this remains a complex and controversial topic.

Another domain that has been less explored, but has a high potential for innovation, is guarantees that can be made to investments in countries where the risks are high but where the investment needs are no less.

The potential of the adjustment of the financial conditions of loans, including ODA loans, to make a contribution to making growth more sustainable should be noted, through flexibility in debt service depending on the economic environment. This has been implemented by the Agence française de développement through 'counter-cyclical loans', with the counter-cyclicality not in the volume of loans granted, but in their service. The debt service can, for example, be partially deferred (or accelerated) based on a price index of exports. It is regrettable that this practice has not been extended further since the first loan of its kind was granted by the AFD, and it shoud be noted that it does not address the vulnerability of the countries that mainly receive grants.

Finally, in the field of macroeconomics one should not forget the sustainability that can be brought about by monetary arangements offering a guarantee of convertibility to a partner who can thus continue to trade even after a negative shock on the balance of payments has led to a depletion of external reserves. This is the case for the monetary agreements between France and the franc zone monetary union, whose contribution to growth sustainability is thus enhanced. As these agreements stipulate that the countries benefiting from the guarantee must respect a certain monetary discipline, the principle, to which we will return later, can be referred to as a guarantee in exchange for rules.

Is compensatory finance obsolete?

One instrument remains emblematic of the struggle against shocks and vulnerability, namely, compensatory financing of (negative) shocks. This was implemented in 1963 through the IMF's Compensatory Financing Facility – an instrument that has since been repeatedly reformed (and even renamed) – and, on a sectoral (agricultural) basis from 1975 to 2000, by the European Commission through Stabex, which was intended to compensate falls in agricultural exports of African, Caribbean and Pacific signatories of the Lomé Convention. Stabex was replaced in the Cotonou Convention by Flex, which has since been supplemented by Super-Flex. The general problem that all systems of compensatory finance for poor countries in the event of adverse shocks – such as shortfalls in export earnings due to exogenous factors beyond the country's control – have to face is the following: in principle, the compensatory finance should be automatic and fast, but its implementation always requires control of the exogeneity and the magnitude of the shock by the body which funds it. This

control inevitably delays and limits the disbursement, especially if it turns into real conditionality. The Stabex story illustrates perfectly this tension between an original principle of automaticity and a growing desire to control the use made of the transfers, which then ceased to be counter-cyclical (Guillaumont and Guillaumont Jeanneney, 2003).

This difficulty should not lead to a rejection of the principle of compensatory financing of shocks, which still has an important role to play in making growth more sustainable in poor countries. However, it does require that such financing be designed and developed on a clear basis. If a conditionality of transfers designed after the shock is hardly compatible with speed of disbursements, it is conceivable to make automatic access to compensatory financing subject to the prior adoption of rules of domestic management of shocks. The countries concerned would thus be encouraged to develop their own means of resilience, either through the quality and flexibility of their economic policy, the management of their foreign reserves, or the adoption of internal mechanisms for the protection of the people most vulnerable to shocks. It would be another application of the principle of 'a guarantee in exchange for rules'. On the other hand, the international capacity for rapid and automatic response to exceptional shocks, in particular those related to natural disasters, still needs to be strengthened and combined with a more lasting support (Guillaumont, 2009b)

Development finance for poverty reduction

It is well recognised that sustainable development implies inclusive economic growth, i.e. associated with the entire population of a country. The financing of sustainable development should lead to the reduction of poverty in its various dimensions – monetary and non-monetary. Its modalities are important here. It should be noted that if funding leads to more stable growth, it also makes it more favourable to the poor, because macroeconomic instability has dispropotionately unfavourable effects on the poor. Regardless of this indirect effect, several major links exist between financing for development and the reduction of poverty, as illustrated by the contributions to this book.

Financial instruments to protect the poor from natural hazards

The previous section has highlighted the role of insurance against shocks that foreign aid could play at the macroeconomic level. At the microeconomic level and within each country, domestic finance, possibly supported by external funding, must help the poor to protect themselves against the risks they face, in particular natural hazards. The high risk of low-income people being caught in a 'poverty trap' when a shock occurs (a poor harvest, a fall in prices of commodities, disease, etc.) makes financial mechanisms that enable them to protect themselves particularly useful. Protection, or insurance, not only has an immediate social effect, it is at the same time a factor in economic growth, especially in rural areas where agricultural innovation is often constrained by climatic risks.

A wide variety of instruments exist including, among others, index-based weather group insurance (indexed to avoid moral hazard, with group insurance

to allocate fairly the proceeds of the insurance between the members) and also adapted forms of credit and savings.

EnabIing the poor through financial deepening and trade infrastructure

Beyond the specific financial instruments intended to deal with the risks, there is the financing of any economic and financial infrastructure that can make development socially sustainable.

Financial deepening, as measured by the increase in the M-to-GDP ratio, may itself be a factor in poverty alleviation, provided it is achieved according to the proper sequence – seeking to increase deposits, before credits, to lead the poor to use the banking system. New technologies can accelerate this process, in particular developments in mobile telephony and in mobile banking, which greatly facilitate the access of the poor to financial services.

It is with this social perspective that 'aid for trade' must also be re-evaulated. At the heart of these flows, along poorly defined contours but with a clear purpose, is the financing of transport and communication infrastructure. This can be directly favourable to the poor by reducing their marginalisation, while also enhancing global economic growth through increased trade.

Looking for impact: A general concern for social impact

The financing of sustainable development has brought into focus a fundamental question of public economics, which has been addressed historically on various occasions – the question of how to assess the social (or environmental) impact of investment beyond its monetary profitability, and how to ensure this is taken into account by the investors themselves. This is both a methodological and a political question. It was at the heart of the Pigou analysis of externalities, but has been contested by proponents of a strict analysis of the profitability of projects, who see externalities as false reasons for the wrong projects (and, more rarely, vice versa for negative externalities). Efforts made at the World Bank to integrate the impact on income inequality into calculations of social profitability (e.g. Squire and van der Tak, 1975) remained without operational application, partly because they raised difficult methodological problems, but mainly because it seemed preferable to act on the distribution of income by redistribution, which meets other limits. In this old debate there has, apparently, been insufficient reflection on the lesson offered in the book by Albert Hirschman, *Development Projects Observed* (1967) that side effects will often reveal themselves to be central, essentially for their sustainability. Finally, what is sought in 'impact investment' is to design investments that, while ensuring some profitability in the short term, will provide prospects of long-term profitability through their social effects (capacity building or environment), then lead to sustainable development.

Is global earmarked funding targeted to the poor?

Another issue raised by the structure of financing for development, and discussed above, is that of vertical funds earmarked for a particular objective. As this objective is usually a social one (the major funds are in the field of health), one can imagine that they would contribute to the social sustainability of development. And yet it is on the basis of their social impact they have often

been criticised. Such funds are sometimes accused of benefitting middle-income countries more than low-income countries or LDCs. To make a judgement on this issue, an analysis is necessary (which Ferdi intends to conduct soon) that allows factors of allocation other than per capita income to be taken into account, in particular the size of the population (higher in middle-income countries), but also the specific needs of the countries in terms of external support for health (for instance, depending on their distance from achieving the SDGs) and their performance or efficiency in moving closer to the Goals. In the case of health, which is to a large extent a global public good, the international community is led to take into account the impact of the funding it grants on a global level, and not only on health in the countries where the funding is being implemented. A similar problem arises for funding to cope with climate change.

Development finance to address climate change

The additionnality issue and the channel of financing

This is an issue the donors do not like. New funding is presented as additional, while it cannot truly or completely be so, since national budgets are subject to the rule of unity and, anyway, public resources are partly fungible. The question of additionality then becomes a matter of degree, which can only be assessed *ex post*. After the fall of the Berlin Wall, Western countries claimed their willingness to assist countries that were previously members of the Soviet bloc would not diminish their development assistance efforts; a claim which the evolution of their efforts has exposed as false.

With funding devoted to climate issues, however, a different question arises. There is no tradeoff between two competing destinations for the same type of financing, but a competition between two or more purposes. Naturally, it is hoped that the funding which will be decided for climate change will not come to substitute for development aid, but much will depend on how the funding will be implemented.

Imagine that the amount that will be mobilised to cope with climate change has been defined, or even decided. You must then choose between multilateral channels (new or existing institutions) and bilateral channels (powered mainly by national resources). The risk of substitution with development assistance is probably higher in the case of bilateral management of funds. It is also higher for adaptation to climate change than mitigation.

The mitigation-adaptation tradeoff

Adaptation concerns every country individually, and the funds a country receives under this name are supposed to be used for its own development. They can be channelled in a different manner and according to specific criteria, but their use cannot be dissociated from that of development aid. There is therefore a risk of fungibility threatening the additionality of resources. The specificity of the criteria that the allocation of funds for adaptation will reflect can only allow them to be differentiated from the other flows of funds for development.

Mitigation of climate change, instead, corresponds for the most part to the production of a global public good. It must be implemented in individual

countries, but in the interest of the planet. The funds made available for this purpose should be allocated where mitigation opportunities are most important, according to the financial conditions that will be associated with them. The financing of adaptation and that of mitigation, distinguished by their purpose, will therefore tend to mainly involve different countries – more developed countries for mitigation than for adaptation.

It is not possible to deal with the geographic allocation of funds for adaptation and for mitigation, whose objectives are different, at the same time. In the following, we assume the respective share of 'climate finance' that will be devoted to each of two objectives to be given by political decision.

The recipients of this financing will be different. If it is relatively easy to find projects for adaptation that lead to development, it is difficult to identify real mitigation projects. Most often, mitigation may occur through the modalities of implementation of all development projects. Therefore, the choice of a model for the allocation of climate finance between countries is essentially a question relating to adaptation funds.

The geographical allocation of adaptation funds

Adaptation funds must meet the needs of countries affected by climate change, for which they are not solely responsible and to which they are less resilient the poorer they are. A problem arises with the allocation of funds for adaptation, insofar as these funds will go through multilateral organisations (general or specific, existing or new). This is the type of problem that all multilateral development banks have to solve and for which they have implemented a system of *performance-based allocation (PBA*) (Guillaumont and Wagner, 2015). In this context, a specific allocation formula will have to take into account a criterion of per capita income and a performance criterion that must be defined (see infra), but in particular it will have to include as a criterion vulnerability to climate change. This requires a measure of vulnerability, such as Ferdi's indicator of physical vulnerability to climate change, or something similar (Guillaumont, 2015). The key is that the measure of vulnerability to climate change should be independent of (either present or future) policy, i.e. a vulnerability for which the recipient countries are not responsible, in order to justify the broad support of the international community. The need for concessional resources for adaptation must therefore be determined by per capita income and the index of vulnerability to climate change, while the performance or effectiveness would be measured by an index of adaptability, which itself might be built according to different options (a general performance index, similar to that used in the allocation of ODA models, an index of the quality of environmental policy, an index of quality of the already financed adaptation operations, a portfolio-type assessment, etc.).

Suppose a simulated global distribution of adaptation funds from a template of the above type, combining three indicators of physical vulnerability to climate change, income per head and performance, according to coefficients representing a degree of international consensus. The model would define for each country the equivalent of a 'real need' or of a right to draw on the adaptation funds, on

the basis of which it could apply to the various institutions of financing through which the adaptation fund would be channelled.

It is worthwhile recalling here that the geographical allocation of the adaptation fund should be consistent with the allocation of development funds, insofar as the adaptation is only a component of development.

Mitigation: What is the allocation issue?

For mitigation, the problem of allocation is different since the aim no longer concerns each particular country, but is the production of a global public good. Moreover, mitigation is not only sought through pure mitigation projects; it is also present across all development projects. The notion of an envelope by country of the concessional funds for mitigation is therefore questionable. An optimal allocation would be one that equalises the marginal cost of avoided CO_2 across countries (with regard to effectiveness), but that would also take into account income per head (for equity). The former depends on the nature of the projects presented. As a first approximation, one could conceive of a formula that, besides the criterion of equity, would use a performance criterion proxied by an indicator of climate policy.

The effectiveness issue: Performance again

For the best use of the resources mobilised against climate change, effectiveness must certainly be taken into account. If it is impossible to measure project by project, a macroeconomic assessment of the performance of the countries where the projects are carried out would be necessary.

But what performance should be assessed? It could be general economic performance and, in this case, its measurement would not differ from one that is eventually used for development aid. It may be the quality of a country's climate policy, i.e. its commitment to the fight against global warming, which would mainly be its energy policy. But this quality, measured by various indices, is more relevant to mitigation than to adaptation. Finally, looking to the PBA as an example, it would be possible, and probably more rational, to have an assessment of the portfolio of projects financed by the funding institution and relating to mitigation and adaptation.

2. The responses in this book to the questions of sustainable development financing

The first part of this introduction shows how numerous and complex the questions relating to sustainable financing for development are. Each requires a debate that Ferdi, through this book, wished to prompt by bringing together respected international experts on development. While far from answering all these questions, the book does offer original views on many key issues. In this second part of the introduction, we bring out some of the key messages that emerge from these views, while insisting on the fact that the essential element lies in each specific contribution, all limited in size.

How the three dimensions of sustainable development and the corresponding vulnerabilities are dealt with throughout the book

New players, new challenges, new tools

The 15 years since the adoption of the Millennium Development Goals (MDGs) have seen profound economic and geopolitical international changes. These have led to a new international consensus on development. The first part of the book is devoted to this major evolution and its implications for the financing of development (Chapters 1 to 8), while the subsequent three parts address, in turn, the way in which financing for development is led to take into account each of the three dimensions of sustainable development – economic (Chapters 9 to 14), social and political (Chapters 15 to 20) and environmental (Chapters 21 to 26).

Giorgia Giovannetti and Mauro Lanati (Chapter 1) describe the different financing instruments (both new and old) and raise the question of the role of aid from new and traditional development stakeholders in international development financing. These points are developed in the following chapters (2 to 8). Believing that the financing for development follow-up process has to be modernised, Serge Tomasi proposes, in Chapter 2, the creation of a new and more comprehensive indicator for official development finance (ODF) that takes better account of developing countries' diverse economic trajectories and the range of financial instruments, regardless of their level of concessionality. This indicator would thus promote an optimal allocation of resources. Justin Yifu Lin and Yan Wang (Chapter 3) also propose expanding the definition of development finance to take into account all forms of funding to support development. Their proposals today are reflected in the OECD's work to develop a concept of 'Total official support to sustainable development' (TOSSD).

In Chapters 3 to 8, the book addresses issues related to the evolution of the balance of power between development stakeholders and its implications for development financing. It gives the floor to authors illustrating the new diversity of development and allows for a comparison of the views of senior representatives from developed, emerging, and recipients of aid countries on the architecture and global governance of development.

While each individual will have his own views on financing for sustainable development issues, all would consider that the strong interdependencies among countries have two major implications. On the one hand, many economic, political and environmental issues are being regionalised or globalised, and only coherent and coordinated action between development actors can deal with these challenges. On the other hand, all countries, particularly the richest, have a responsibility for the fate of others, notably of the most vulnerable. Sustainable development, in all its components, is therefore more than ever a shared concern.

The rest of the book addresses each of the three dimensions of sustainable development through their corresponding vulnerabilities.

Dealing with the financing of economic sustainability, especially in the most vulnerable countries, Chapters 9 to 16 provide answers to issues of the mobilisation of domestic and external resources, how to better measure these

resources and how to assess their real potential. This second part of the book also explores which instruments are able to promote the reduction of economic vulnerability and what can be done in vulnerable countries and fragile states.

The next part (Chapters 15 to 20) deals with the financing of social and political sustainability, and offers a set of additional thoughts on the socio-economic, financial, agricultural and health risks faced by the poorest, as well as the tools to be developed to confront them.

The last chapters (Chapters 21 to 26) focus on the financing of the environmental dimension of sustainability. In this final part, various mechanisms to mobilise sufficient funds to combat climate change and to preserve and promote the environment are proposed and debated, as well as some principles for the allocation of these resources in order to make their use as effective and relevant as possible.

Faced with huge financial needs, an uncertain global governance

The above-mentioned changes require a renewed global development financing architecture to be conceptualised, both its objectives and its means of implementation.

The international community is engaged in the definition of an agenda for development after 2015, expanded to sustainable development and involving a sharing of responsibilities between the different development stakeholders. These issues are recalled in particular by Barry Herman (Chapter 8), who finds that the Sustainable Development goals (SDGs) reflect in part this change and are a concrete materialisation of the rapprochement between the development, environment and climate agendas. The development and sustainable development agendas are now one, and the integration of climate issues into the new development goals should promote coherence in the management of these issues, starting with the decisions to be taken during the three major upcoming international events of this year.

However, according to Pierre Jacquet and Varad Pande (Chapter 26), the plurality of the SDGs reflects the difficulty of reaching a global consensus on sustainable development, particularly because the actions to achieve the objectives are difficult to identify, and because the relationship between the development and sustainable development agendas turns out to be complex due to different chronological priorities. For these two authors, the alignment of the objectives and interests of the various stakeholders is the key to the ongoing negotiations. Barry Herman (Chapter 8) considers that it would be naive to minimise the difficulties to obtain a set of binding decisions adopted by all that can satisfy the high, but legitimate, ambitions displayed today. He argues that in order to prevent the Addis Ababa conference from producing empty outcomes, the agreement or the message will have to be as clear and strong as that of Monterrey and will have to be endorsed by all, while a set of forums on development has developed outside the United Nations area since Monterrey (notably the Global Partnership for Effective Development Cooperation, the G20 Development Working Group, and so on).

The credibility of the agenda will depend on the ability of the development stakeholders to promote newly adjusted and relevant concepts of financing. That is the purpose of this book, which investigates how the new financing for development enables the international community to tackle vulnerabilities that affect its sustainability.

The preparatory work for the three main conferences of the year has led to the outlining of a first diagnosis of the financing needs for sustainable development agenda. The main message coming out of this perilous exercise is, according to Giorgia Giovannetti and Mauro Lanati (Chapter 1), that the needs are enormous, and great exceed the funding capacity of traditional donors. Furthermore, Pierre Jacquet and Varad Pande (Chapter 26) think that sustainable development financing is about much more than just money, and that the question of ways and means should be at the core of the debate. The challenge is therefore to mobilise additional resources for the new objectives of the international community and to define the most effective manner to achieve these objectives.

The role of the private sector in the financing of sustainable development

A sustainable improvement in the living conditions of populations requires the funding of a large number of structural elements of development. Rich countries became developed by the adoption of rules and institutions favourable to a market economy. Jaime de Melo and Laurent Wagner (Chapter 18) recall that no country has known economic progress in the long run by closing itself to trade, which is an engine of growth rather than the other way around, and that growth trickles down. They emphasise the fundamental role of private development actors, and the importance of funding to promote trade as a way to alleviate poverty and provide the economy with the means to develop sustainably.

The economic progress made over the past two decades by most middle-income countries, including emerging countries, validates this principle. International cooperation by rich or emerging countries and the multilateral development banks, the great diversity of which is recalled by Jean Michel Debrat and Mamadou Lamine Loum (Chapter 7), remains legitimate to support this progress, which is sometimes fragile, through a set of financing instruments adapted to potential market weaknesses. Several chapters deal with essential instruments for the financing of sustainable development, such as concessional and non-concessional loans or better access to specific risk-management mechanisms. They emphasise the complementarity between the roles of private and public stakeholders in the financing of sustainable development, in particular when market weaknesses prove too numerous.

This is particularly the case in vulnerable countries. It is also the case for the funding dedicated to the promotion of regional and global public goods, which requires the fair sharing of means and efforts across all countries and the adoption of common regulatory rules.

If the future of financing for sustainable development depends on funding from the private sector, combined with suitable regulation and targeted support from the public sector, this book shows that there is a need for differentiation

of development goals and types of funding across countries and according to the challenges that they face, with a particular focus on the two things that are most sensitive to finance – the development of vulnerable countries, and the preservation and promotion of regional and global public goods.

The potential of financing for sustainable development in poor countries

Giorgia Giovannetti (Chapter 1) stresses that no individual source of financing is independently sufficient to successfully provide the required resources for sustainable development financing. However, if the overall funding needs are considerable, they are particularly acute in countries facing strong structural handicaps where ODA is often an important source of funding. ODA aims to address economic, socio-political or environmental and climate vulnerabilities while contributing to mobilising other potential sources of financing of the economy, whether public or private, local or external.

In the domestic field, better mobilisation of domestic public resources may relieve national budgets that are under tension and release resources that are essential to development financing. Through an alternative measure of *non-extractive resource* tax efforts in developing countries, Gerard Chambas, Jean-François Brun and Mario Mansour (Chapter 11) argue, however, that the potential for additional resources that would come from an improvement in policies is not necessarily that high in the short term. This is particularly the case in many low-income countries, fragile states, sub-Saharan African countries and, in particular, for member countries of West African Economic and Monetary Union (WAEMU), where the tax potential outside of extractive resources is better exploited than in many countries of Asia and Latin America, and most countries that are largely dependent on extractive activities. For Chambas, Brun and Mansour, the debate should focus more on public expenditure effectiveness and the need to improve tax neutrality than on the mobilisation of additional fiscal resources.

A specific contribution comes from Grégoire Rota-Graziosi and Bertrand Laporte (Chapter 24), relating to the extractive activities tax system. They analyse the factors of an optimum mining taxation. Highlighting the contrast between the slight increase in tax revenues from the mining sector in Africa since 1995 with the strong growth in revenues from exports of the companies that exploit them, Rota-Graziosi and Laporte underline the difficult tradeoff between taxation and attracting investors to extract and exploit resources. They stress the three principles for a fair sharing of mining revenue and to avoid the 'resource curse': transparency, simplicity and neutrality. Moderate efficiency of mining taxation makes countries vulnerable to aggressive tax optimisation practices. Sufficient capitalisation and a good VAT liability of mining companies should limit these practices, but, for these authors, these two conditions are rarely met in developing countries.

Released public domestic resources should allow local and national authorities to stimulate the mobilisation of private domestic resources in order to finance sustainable development in the long run. Bruno Cabrillac (Chapter 10) explores

the conditions of an effective private savings mobilisation policy, recalling nonetheless that each measure may be subject to specific tradeoffs with other economic policy objectives. A first requirement is to ensure the stability of prices through good macroeconomic policies. This involves correctly adjusting the level of financial repression to encourage investment without harming savings, increasing taxes with relevance in order to raise public savings without stifling private savings, and liberalising capital to develop private savings by avoiding increasing financial instability. A second condition is a high quality banking sector, which requires the following: increasing the capacity of the regulator, which has a cost; defining well the degree of regulation; promoting the opening-up of the financial market, which increases the need for regulation; implementing a proper monetary policy; and guaranteeing bank deposits while taking measures to prevent the moral hazard an implicit state guarantee may cause. In addition, the mobilisation of private savings requires the promotion of financial inclusion – which is also dealt with in Chapter 17 by Sylviane Guillaumont Jeanneney and Roland Kpodar in the case of poor countries – and the implementation of specific policies such as, for instance, the adoption of fiscal incentives for private savings.

In addition, the complexity is not so much in the recommended 'recipes', which are fairly conventional, but in their applicability to harsh environments. In Chapter 17, which is devoted to the promotion of pro-poor financial development, Sylviane Guillaumont Jeanneney and Roland Kpodar emphasise that in countries where the proportion of population who is 'underbanked' is high, priority must be given to the promotion of access to a powerful and innovative payment system and the safeguarding of savings, before access to credit. Access to credit can then be promoted via better geographical coverage of banks and innovations like mobile finance, a better definition of property rights and better financial education of the population.

The released resources should also contribute to attracting private external resources, including foreign direct investment and remittances from migrants. If, as claimed by Bruno Cabrillac (Chapter 10), these resources alone will not cover future funding needs, they are still a very important potential source. Using several scenarios based on hypotheses on the evolution of a country's income and inequalities between countries, population, education, and costs of migration flows, Frédéric Docquier and Joël Machado (Chapter 12) believe that by 2100, the share of remittances from migrants in the GDP of low-income countries, which is already significant today, should at least remain the same and, under some scenarios, could be multiplied by four, or even by ten in an optimistic scenario.

The central question remaining is how to direct these flows towards the financing of sustainable development. The book focuses on the incentive effect of an adequate taxation, and on the importance of supporting specific instruments, such as societal entrepreneurship. Jean-Michel Severino and Pierrick Baraton (Chapter 20) specify its potential and the conditions for its development. The authors analyse companies whose objective is profitability but that try to take

into account externalities related directly or indirectly to their activities. The viability of this form of financing for sustainable development lies in the fact that it can allow these companies to solve long-term strategic problems for their group, such as markets affected by climate change, environmental degradation, poverty, and so on. Severino and Baraton admit the difficulty of measuring the extent of societal entrepreneurship, which was estimated at US$7 billion of assets in sub-Saharan Africa in a recent study by JP Morgan. Considered as being complementary to ODA, in terms of their amount and by their targets, these investments are expected to accelerate. For these authors, the development of societal entrepreneurship implies two conditions: i) regulators and public authorities have to adopt a legal and regulatory framework that is conducive to societal entrepreneurship; (ii) mission investors must be able to better account for the effectiveness of their contribution, although their impact may still be difficult to assess.

The persistent role of ODA in vulnerable countries

The book thus highlights the persistent importance of ODA for the poorest and most vulnerable countries, while it should be noted that there has been a recent tightening of public budgets devoted to development policies in many OECD/DAC countries.

According to Paul Collier (Chapter 15), the conditions for integration into the international market economy are not satisfied in fragile countries – they are isolated, their domestic markets are too small, and their production units are atomised, so they are therefore characterised by a general inefficiency, a sub-specialisation, the unavailability of certain goods and services essential to production domestic due to prohibitive costs, and so on. The author draws a parallel with the Great Britain of the eighteenth century, when there was a similar need for investor 'pioneers' and 'risk takers' who were able to invest in activities that were potentially sustainable in the long run, but for which the return on investment remained hypothetical. Collier notes that a fragile state does not automatically produce such investors, and thus considers development assistance as the primary means of encouraging these indispensable pioneer investors to intervene in long-term viable activities, including fighting against remoteness factors, by subsidising infrastructure and capital and by allowing investors the possibility to insure against political risks.

In poor and vulnerable countries, ODA plays a critical role (the so-called 'catalytic effect') in mobilising other sources of financing in an economy.

ODA is expected to improve the mobilisation of domestic public and private resources (Chapter 10), including through the promotion of local actors (Chapter 7) and the promotion of national banking and financial institutions (Chapter 17).

Aid can also facilitate activity by subsidising loans to SMEs and agriculture (Chapter 17), by granting guarantees (Chapter 14), and by contributing to making available a set of tools to reduce the risks facing the most poor (Chapter 16).

Julia Benn, Cécile Sangaré and Mariana Mirabile, in Chapter 14, specify that the guarantees for development must be considered as a complement to

traditional forms of aid, and not as a substitute. Furthermore, they emphasise that guarantees remain an underutilised instrument, although they note that the amounts invested through such guarantees doubled between 2009 (US$3.2 billion) and 2011 (US$6.4 billion). Their use should be increased when market conditions enable additional resources to be mobilised for development, i.e. when there are good regulatory and legislative frameworks, good access to reliable payments systems and open and transparent tender processes.

With regard to the role of ODA in risk reduction, Alain de Janvry and Elisabeth Sadoulet (Chapter 16) point out that exposure to uninsured risks is a major source of low growth and poverty. They believe that in poor countries where people are most exposed, ODA should promote the use of financial products such as weather index insurance or flexible savings and credit products. ODA should also allow the growth of microfinance through the reinsurance of credit lines, support the installation of credit bureaus to improve the sharing of information on customers risk, and further improve access to credit for emergency funds.

ODA must also contribute to reducing the health risks of the most vulnerable. However, according to Michel Sidibé (Chapter 19), the global health funding system suffers from profound evils which must be quickly tackled: i) insufficient funds; (ii) poor coordination, often increased by national sovereignty which undermines transnational coordination of global health financing in the absence of strong accountability mechanisms; (iii) a dependency of poor countries on external financing; (iv) volatile and unpredictable aid; (v) unequal distribution of resources, to the detriment of the most vulnerable; (vi) socio-economic and political factors of health remaining neglected in health policy; (vii) weak accountability of most of stakeholders; and (viii) under-investment in the prevention and anticipation of future diseases and pandemics. Sidibé recommends the adoption of a global compact for health with the implementation of a system of minimum social protection around the world funded by international solidarity which would be increased to 2% of global GDP to this end, the creation of a global equity health fund, the adoption of a global consensus on the universal right to health and the ability for all to be able to exercise this right, and finally the adoption of an international regulatory framework to compensate for vulnerabilities and inequalities.

The development of new uses of development assistance to facilitate its catalytic effect materialises essentially through the blending of public and/or private financial tools, also called ‘mixed financing’. Pierre Jacquet and Varad Pande (Chapter 26) consider that it should no longer be regarded as a subsidiary of the discussions on financing for development, but rather as a key method. For them, blended finance creates favourable conditions for sustainable development by orienting private interests towards the promotion of global and local public goods. It can encourage a renewed focus on performance and results, and must therefore be recognised as a structural element of the post-2015 agenda.

In addition to public-private partnerships, subsidies on loans (a classical tool of development banks), blended finance and results-based financing programmes, Michel Sidibé’s proposal (Chapter 19) of a Global Health Equity Fund bringing

together public and private sectors and civil society that can mix their resources and improve their coordination, and the provision of public guarantees for lending operations (Chapter 14) provide examples of these new uses of public resources.

The relevance of the use of aid to support inclusive economic growth is also highlighted by Jaime de Melo and Laurent Wagner (Chapter 18), who remind us that aid for trade in developing countries, by contributing to the improvement of infrastructure, proves to be a beneficial tool for exports and is positively correlated with a reduction in poverty. According to de Melo and Wagner, the effects of trade liberalisation on inequality and poverty are specific to the context and the structure of each country. The authors encourage donors to engage in a political dialogue with recipient governments to improve regulatory frameworks and to ensure the exercise of competition in the provision of services.

As ODA is partly based on external debt, however, it is essential to ensure that the structure and the macroeconomic stability of a country are not adversely affected by development assistance. It is with this in mind that Ugo Panizza (Chapter 9) suggests a method for the determination of the concessionality of development assistance loans that is evolves over time and is thus more suited to the dynamics of the borrower. This would consist in disbursing the money according to the needs of the borrower and then determining, at the time of repayment and according to predefined clear rules, the degree of concessionality (which could be 100% if needed, i.e. a pure grant) depending on the situation of the country (indexed to GDP). A grant would thus be decided *ex post* according to *ex ante* arrangements on debt cancellation rules. This could discourage irresponsible loans, but could also lead to irresponsible borrowing.

Development assistance goals are numerous, and ODA amounts are probably still insufficient to finance all of them. Beyond a possible increase of ODA from the DAC countries, which for many contributors to book would be desirable, other external public financing can be a complement.

Additional external resources of traditional ODA

In addition to traditional aid from OECD/DAC countries, external resources are available. They may be 'innovative' due to the mechanism that generates them, or come from sovereign wealth funds or from a greater contribution by emerging countries to development financing for poor countries.

Pierre Jacquet and Varad Pande (Chapter 26) point out that the innovative nature of financing has often consisted in applying a classical instrument (tax or loan type) – or a mix of instruments – to a sector or a new object. Philippe Douste-Blazy and Robert Filipp (Chapter 25) consider that the amounts generated by the 'leverage effect of development assistance' represent to date nearly US$8 billion, almost entirely in the health sector. In their chapter, they study the possibility of replicating these mechanisms in other sectors, including education, food security, biodiversity and addressing climate change, for which

Arild Angelsen proposes a retrospective and prospective assessment of the REDD+[7] initiative (Chapter 23).

Douste-Blazy and Filipp believe it could be difficult to apply the mechanisms which have funded neglected parts of the health sector to the education sector, due to the much longer time it takes to measure the social return of an investment in education (the result of an investment in education is often measured only when the recipient cohort reaches adulthood). This long delay is likely to deter many investors. Douste-Blazy and Filipp instead propose the creation of an investment bank for education to facilitate public-private co-funding of projects. This bank could be a subsidiary of the Global Partnership for Education.

Regarding biodiversity, Douste-Blazy and Filipp draw attention to the existence of the Endangered Species Technology & Innovation Fund (ESTIF), which monitors and controls the trade in endangered species. This fund is financed by a portion of the return on investment of technology companies that participate in it. Such an initiative is of interest to companies because it allows them to disseminate their technology and they can hope for an opening-up of markets. The authors thus illustrate the potential of innovative financing when a company has a business interest in subsidising a public interest initiative.

Another potentially important source of external financing comes from sovereign wealth funds. Giorgia Giovannetti and Mauro Lanati (Chapter 1) remind us that assets managed by these funds represented approximately US$7 trillion in 2014, of which 60% comes from exports related to gas and oil, mainly from resource-rich emerging countries. For these authors, ODA can have a role to play in countries' ability to establish sovereign wealth funds, including through technical assistance and expertise in the management of the funds, to direct part of their institutional investments to the poorest countries.

Finally, the increasing contribution of the emerging countries to development financing for the poorest countries opens up new prospects for international cooperation and is changing, little by little, the traditional patterns of cooperation.

Justin Yifu Lin and Yan Wang (Chapter 3) study the role of China in development cooperation and consider the Chinese experience as a model of structural transformation for poor countries. According to these authors, the crisis in Western countries in 2008 associated with the difficulty of economic theories to consider the complexity of the world today has caused a loss of confidence of developing countries in the Washington Consensus. Contrasting trajectories of the West and the Orient explain why poor countries are now turning to the East to find solutions to their development issues. Basing their thinking on the theory of comparative advantage and a joint learning model, Lin and Wang consider that the solutions lie in the fact that the comparative advantages of China in infrastructure projects meet the problems of infrastructure in Africa, while China benefits from its cooperation with Africa's human and natural resources, i.e. what China itself lacks. In addition, through its overseas investment and industrial modernisation, China promotes the development of labour-intensive light industry (which the country itself has abandoned) in poor countries whose

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labour cost is now lower. Lin and Wang offer a vision of South-South cooperation based primarily on trade and the law of the market.

In a broader and more institutional vision of cooperation between developing countries, Debapriya Bhattacharya analyses the role, opportunities and challenges of South-South cooperation (Chapter 4). For Bhattacharya, the strengthening of the position of Southern countries in the world economy promotes increased contributions by them to the development of low-income and middle-income countries. Southern countries must exploit these economic dynamics to redefine some basic rules of the international development cooperation framework, which currently favours the OECD. This implies a greater structuring of the concept of South-South cooperation (which would benefit from a clearer institutional framework based on principles adopted by stakeholders), defining the rules of cooperation, and promoting tools beyond the simple sharing of knowledge and capacity-building, such as the blended finance. Bhattacharya sees as necessary the rapprochement of cooperation models between emerging economies and the OECD/DAC countries to promote the development of a triangular cooperation that is beneficial to all.

The analysis of Hiroshi Kato and Masato Tokuda (Chapter 5) corroborates this need for rapprochement between cooperation models, and emphasises the fundamental role that the traditional donors can and must play in the promotion of South-South cooperation. Pointing out that it often takes the form of technical cooperation and a sharing of knowledge, they believe that South-South cooperation cannot be summed up as an exchange based only on the law of the market. They remind us that, despite the prominence of the private sector in international development, many aspects of development are not subject to the markets, including the transfer and sharing of knowledge in the management of the public sector. Thus, Kato and Takuda believe that traditional donors enjoy the experience, tools, methods and resources that are appropriate to the needs of the Southern countries that are willing to engage in South-South cooperation but have limited sharing and knowledge-transfer capabilities. Stressing also the importance of this rapprochement, Justin Yifu Lin and Yan Wang (Chapter 3) caution against the risk of international cooperation where emerging partners would not have the influential place they deserve. According to Lin and Wang, the emergence of new multilateral development banks and funds seems inevitable, and they consider this a positive element for international development. An example is the recent establishment of the New Development Bank. For Jean-Michel Debrat and Mamadou Lamine Loum (Chapter 7), the Bank usefully complements the inadequate supply of finance in Asia, but for these authors, as well as for Benoit Chervalier (Chapter 6), its creation raises the question of its articulation with the traditional development banks, who are sometimes themselves competing with each other, and vertical funds. One of the options put forward by Debrat and Loum, echoing a recurring criticism, is to grant a higher power to the emerging countries in the governance of the major multilateral development banks. Another, complementary, option is to refocus the action of regional banks around projects that promote regional integration. For this

reason, Patrick Guillaumont and Sylviane Guillaumont Jeanneney (Chapter 13) suggest that the African Development Bank (ADB) increases the envelope dedicated to regional operations and allocates it on the basis of an 'indicator of need for regional integration'. This indicator would reflect both the narrowness of the internal market and the distance of external markets. It could possibly be supplemented by an indicator of countries' commitment to promoting regional integration. It would avoid the effects of thresholds and encourage countries to engage in a process of regional integration. For these authors, the loss of customs revenue due to the strengthening of regional integration could be compensated over a transitional period by budgetary aid or support of a different nature.

According to Benoit Chervalier (Chapter 6), the need for rationalisation of the multilateral development ecosystem should be addressed by the G20, the only institution able to seize this issue and make a rational response.

This redistribution of international power relations and the evolution of cooperation models, both institutional and instrumental, call into question the practices of multilateral development banks. One of the major reforms being debated deals with maintenance of their concessional windows, which Benoit Chervalier (Chapter 6) considers is essential to cooperation focused on the poorest countries (except the specific case of the Asian Development Bank).

The financing of global public goods

The now urgent need to preserve and promote regional or global public goods justifies a broadening of development goals to include environmental, climate and security issues. Compared to the traditional problems of development, the difficulty of overcoming these new issues is twofold. First, it is necessary to mobilise more funds. Second, there is a need to coordinate the international community as a whole to make these policies efficient (Chapter 8), in particular because of the risk of stowaway behaviour as some countries seek a free ride thanks to the public nature of these goods (Inge Kaul, Donald Blondin and Neva Nahtigal, Chapter 21).

The introduction of sustainability to the international community's goals implies that economic actors agree to pay the corresponding extra cost usually observed in the short run and reduce their preference for the present. To do this, governments must either lay down binding standards (to the possible detriment of competitiveness) or create the right incentives through tax or by subsidising the cost of sustainability. They can also choose to create a specific market similar to the system of payments for environmental services (REDD+) based on the carbon market, as analysed in Chapter 23 by Arild Angelsen.

As Gaël Giraud (Chapter 22) notably recalls, the financing of regional and global public goods by domestic taxation tools or ODA is limited by the constraints that weigh upon public budgets. As ODA is struggling to fully assume its traditional goals, it is not in a position to finance the US$100 billion of public resources per year expected for the Green Climate Fund. For Inge Kaul (Chapter 21), the principle of additionality must prevail. If in poor and vulnerable countries ODA can contribute to 'turning green' development projects to make them more

sustainable, ODA and resources for global public goods are complementary but different, and must be additional.

The book explores several ways to mobilise funds for environmental and climate challenges.

One option is to create a market for a specific environmental good, but experience shows that the establishment of systems of payments for environmental services can be delicate. Arild Angelsen (Chapter 23) takes stock of the REDD + initiative for forests, one of the main experiences in this area, and offers a series of recommendations for the future of this method of management of environmental goods. He finds that the inadequacy of the carbon market has made REDD+ highly dependent on aid. According to Angelsen, this dependence is likely to compel REDD+ to produce measurable outcomes in the short run, with the same problems that face results-based financing of aid systems – pressure on public budgets and controversies over performance measures, criteria and the definition of the objectives. If this 'aidificiation' sounds like a failure of REDD+ as an ambitious system of payments for environmental services, Angelsen offers five lessons: i) we should learn from the experiences of results-based approaches in other areas of financing to avoid known pitfalls; (ii) disbursements must be made more credible, which involves discouraging 'the bureaucratic culture of annual budget expenditure', including promoting multi-year financial commitments; (iii) we need to be realistic about private sector funding of REDD+ and find good incentives that generate positive externalities favourable to public goods like the global climate, such as carbon taxes or caps and exchange systems; (iv) money is not the only factor, REDD+ should also be able to encourage adoption of appropriate reforms; and (v) rather than thinking REDD+ as a payments for environmental services policy, we should perhaps be consider it as a goal.

Another option to contribute to the Green Fund, proposed by Gaël Giraud (Chapter 22), is monetary in nature. Based on the work of the IMF (2010), the author envisages to feed the own funds of the Green Fund a contribution of the top 21 countries responsible for the stock of greenhouse gases, on the basis of their foreign-exchange reserves, denominated in Special Drawing Rights (SDRs) at the IMF and completed by an additional SDRs issue. An annual fund of US$100 billion could reasonably be split into US$40 billion of subsidies intended solely for adaptation projects and US$60 billion intended, on the one hand, for mitigation projects (accounting for five-sixths of US$60 billion) and, on the other, for adaptation projects (one-sixth of US$60 billion). His proposal would not involve increasing the money supply and would make it possible to fund US$100 billion of annual loans over ten years at a minimal cost for the 'advanced' countries, with the 'historic polluters' nonetheless remaining the main contributors. The need for the following years' grants would be supplemented by additional issues of which the inflationary and fiscal cost would be minimal.

As illustrated by the previous proposal, regardless of the option envisaged for the mobilisation of the necessary resources for the Green Fund, it will involve the establishment of new mechanisms, but also, and above all, both vigorous and consensual political choices.

In a complementary way, Inge Kaul estimates that there is a need to better identify the resources available to address climate climate following the OECD-DAC example for development assistance.

The challenge is also to ensure relevant use of the funds mobilised for each aspect. Kaul estimates that adaptation and mitigation policies still suffer from a lack of clarity and are struggling to define the needs and the, which necessary to achieve the goals.

A challenge of public goods financing is also the governance of mobilised funds. In his proposed monetary option, Gaël Giraud favours entrusting the management of the mobilised funds to the Green Fund, rather than to the IMF itself, according to the principle of one vote per country. Inge Kaul proposes to outsource the management of mobilised funds for the climate, irrespective of their origin. Kaul envisages the creation of an independent international agency, with technical expertise, led by a president with public and private experience, and with a mandate to manage climate funds in a supra-national way and to ensure their overall effectiveness beyond national considerations. This agency would also be competent to manage geographical allocations. In any case, Gaël Giraud points out that, regardless of the option chosen to mobilise and manage climate funds, substantial efforts would be required to support state loans and this should be the responsibility of the international banking and financial institutions that have historically partnered states.

Priority allocations

The issue of the allocation of concessional resources, which involves a public decision, is discussed several times in the book. The global redistribution system must be improved and adapted to the new problems that international public funds should help to resolve.

According to Serge Tomasi (Chapter 2), for concessional resources such as official development assistance, their relative scarcity associated with the widening of development issues and the gradual decrease in the number of low-income countries implies that these resources have to be mainly allocated in favour of most vulnerable and fragile countries. Tomasi suggests the adoption by main ODA donors of an allocation rule targeting the least developed countries. Under this rule, 50% to 70% of ODA would be granted to the poorest countries. Paul Collier's analysis of fragile states (Chapter 15) campaigns for an increase in ODA in their favour. By positioning itself in favour of the maintenance of the concessional windows of multilateral development banks targeted at the 30 countries that will probably be low-income countries in 2030, the analysis of Benoît Chervalier (Chapter 6) strengthens these positions.

A number of authors in this book prefer targeting the most concessional resources in favour of the most vulnerable countries, although Michel Sidibé (Chapter 19) believes that health funds should be allocated in favour of the most marginalised and most vulnerable people, regardless of their country of residence.

Given the extremely important role of aid in poor and vulnerable countries, and in particular in LDCs, and the role of public resources in the financing of global public goods, most authors insist on the need to clarify the rules of allocation of official development assistance and the resources dedicated to the issue of climate change. This is an endeavour to which Ferdi is committed and which will be the subject of another book.

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PART ONE

OVERVIEW: FINANCE MAPPING FOR DEVELOPMENT

1

Financing Development in Risky Contexts

GIORGIA GIOVANNETTI AND MAURO LANATI

INTRODUCTION

The development finance landscape has experienced important changes since the Millennium Development Goals (MDGs) were launched in 2000: the participation of new actors, with a consequently different balance of power between emerging and developed countries and a growing role for South-South development cooperation; the outbreak of the financial crisis and the debt crisis in Europe, which have tightened budget constraints and attracted increasing attention to aid effectiveness considerations; a renewed debate on the role of official development assistance (ODA) and its contribution not only to the MDGs, but also to other global public goods such as climate change mitigation or the preservation of biodiversity; and the launch of new instruments and the increasing role of philanthropic institutions. Many of these changes have affected in particular countries in situations of fragility or conflict and generally in risky situations.

At the same time, the development agenda is focusing more on economic growth, social inclusion and, in the aftermath of the Rio+20 conference of 2012, environmental sustainability in a coherent and mutually reinforcing way. The debate on the post-2015 development agenda has proceeded separately from that on its financing and implementation, in line with the tradition that MDGs were articulated independently of a financing framework, as established in Monterrey in 2002. However, in a context of crisis and necessary fiscal consolidation in many countries, and one in which multiple local and global objectives compete for funding, the discussion of the post-2015 goals had to be integrated with a consideration of supporting financing for implementation. Only with a joint consideration of both policy and finance can potential synergies be explored, inefficiencies avoided, and priorities defined in a transparent manner. Establishing goals without reflecting on the appropriate financial means is simply no longer credible.

Against this background, new financing instruments have emerged within and in addition to ODA. These instruments create new opportunities, but might also increase fragmentation and transaction costs, and bring about a loss of transparency and a disregard of established forms of best practice in development cooperation.

This chapter describes some recent changes in the development finance landscape and instruments, against the background of these new (global and local) challenges and a situation of high uncertainty. Its emphasis is on the analysis of possible positive complementarities and externalities between different instruments while suggesting how to avoid side-effect distortions and conflicts between both instruments and goals. It stresses the most innovative ways that different donors could contribute to the new development architecture and highlights to what extent the new international challenges can be met by the new set of actors and financial instruments. In countries in a fragile situation, however, development assistance is often provided in the same way as in countries with stronger institutions. This might not be the most efficient way and the failure to 'adapt' aid delivery to the special conditions of fragile states implies a cost, borne mainly by the local population.

Section 1 describes the different financing instruments (both new and old), Section 2 provides relevant data on their relative shares and developments over time, Section 3 concentrates on ODA and describes some issues related to this form of development finance, and Section 4 concludes.

1. The state of the art

Access to financial capital is a crucial determinant of a country's development. ODA has been for decades the main available source of financing for many countries, notably the poorest, where mobilisation of domestic resources is very low and private capital tends not to go. However, no individual source of financing is independently sufficient to successfully tackle the balance between poverty reduction and environment protection, or the tradeoff between economic, financial, social, and climatic instabilities and the sustainability of development; in other words, the recent challenges of development.

The new awareness of the different needs, together with changes in the donor landscape, triggered several important changes in the sources of finance, as well as in the terms upon which financing is provided and the kinds of projects/countries being financed.[1]

There is a continuum of financing sources that goes from official development assistance to mobilisation of domestic resources and includes a variety of funds – public and private – flowing from different actors, targeting different objectives and giving rise to heterogeneous impacts. Some of these sources have been recently labelled 'innovative development finance'. But there is no agreed definition of exactly what innovative development finance includes, even though there seems to be some consensus on the fact that it includes new ways to raise funds spent on development purposes, possibly in a predictable and stable way. In fact, in a context where new needs (such as green growth, mitigation and social protection) increasingly ask for new resources, innovative sources of finance are seen as a response to the unstable performance of the more traditional sources and as a way to further involve the private sector (UNDP,

1 We do not address here the issue of 'aid orphans'; see ERD (2009) and its background papers.

2012). Up to now, however, such new resources have been used only on a small scale and for specific purposes, including global health financing and climate change mitigation and adaptation (UN DESA, 2012). Their potential is expected to increase significantly in the future and, according to recent estimations, they may even become large enough to outpace global ODA flows, especially if effective mechanisms of leverage from international financial and climate transactions are fully exploited.

In what follows, we briefly describe the different financing instruments, starting with so-called 'traditional forms' – ODA, other official funds (OOF) and aid for trade – to arrive at (some forms of) 'innovative finance'.

1.1. Traditional forms of development finance

Official development aid encompasses public international flows with specific characteristics.

1. Only aid to countries on the DAC List of ODA Recipients counts as ODA. ODA focuses on flows reported by OECD DAC members and an increasing number of non-OECD donors. However, the list does not include Brazil, China and India, which provide the vast majority of ODA-equivalent resources in the form of South-South cooperation (SSC).

2. While most ODA is provided in the form of grants, concessional loans constitute an important part of official development assistance. In this regard, the OECD-DAC recently modernised the definition of ODA in order to (i) better target those countries that are most in need; and (ii) give more credit as ODA to loans that are more concessional in character. The previous definition included each transaction that was *concessional in character* and conveyed a grant element of at least 25%, calculated at a rate of discount of 10%. In the last DAC High Level Meeting, the DAC opted for an assessment of concessionality based on a differentiated grant equivalent method and discount rates in order to incentivise lending on highly concessional terms to those countries most in need.[2]

The MDG declaration of September 2000 recognised the prominent role of foreign aid in reducing North-South inequality: the 13th target of the MDGs encouraged industrialised countries to '*grant more generous development assistance, especially to countries that are genuinely making an effort to apply their resources to poverty reduction*'.[3] Furthermore, the MDGs re-affirmed the commitment of rich countries to target 0.7% of GNP to poor countries in the form of ODA, which was first established in a 1970 UN General Assembly Resolution. The international attention on the MDGs undoubtedly contributed to increasing the political momentum of foreign aid that, in the last 15 years, has

2 For more details on the recent changes adopted by OECD-DAC, see Section 3 of this chapter.

3 United Nations Millennium Declaration, 8th plenary session, September 2000 (available at http://www.un.org/millennium/declaration/ares552e.htm).

shown the highest yearly growth rate since 1960.[4] According to OECD statistics, gross total ODA disbursements from all donors increased from US$38.4 billion in 1960 to more than US$187 billion in 2013 (of which 85% consists of 'grant disbursements', while the remaining share is 'loan disbursements'), and it rose by US$89 billion in just the last 15 years since 1998.[5]

Other official flows (OOF) consist of transactions by the official sector with countries on the DAC List of Aid Recipients that do not meet the conditions for eligibility as ODA, either because they are not development motivated or, if they are, their grant element does not meet the ODA requirements. The main transactions included in the OOF category are official export credits, official sector equity and portfolio investment, and debt reorganisation undertaken by the official sector on non-concessional terms.[6] This category accounts for a very small share of the total official and private flows towards developing economies: for instance, in 2012 the OOF net disbursements accounted for 7.7% of total ODA from DAC countries.[7] Along with ODA, OOF will be encompassed in a broader and more inclusive measure of development finance called Total Official support for Sustainable Development (TOSD), which aims to cover the totality of resource flows towards developing countries and multilateral institutions (both concessional and non-concessional). The components of this measure are still under scrutiny by the DAC and the collection and presentation of TOSD data in OECD-DAC statistics will start no earlier than 2016 (OECD, 2014d).

Aid for Trade (AFT) is a WTO-led initiative that mobilises resources to overcome supply-side and trade-related infrastructure obstacles, which constrain developing countries' ability to engage in international trade (Cadot and de Melo, 2014). This form of aid more than doubled in real terms following the Paris Declaration in 2005, reaching over US$54 billion in 2012 (OECD, 2014b), but this is still less that the share of other types of aid. In contrast to ODA – which in the last decades has been mainly focused on social sectors – Aid for Trade was predominantly channelled towards investments in the productive sectors of the developing economies, '*such as economic infrastructure, support for building productive capacity, improving transport times and costs, and improving standards certification*' OECD (2014b).

1.2. Non-traditional financial instruments

International loans and the role of emerging donors. South-South cooperation (SSC) has rapidly become a valid supplement – and sometimes an alternative – to traditional North-South relations and is playing an increasing role in the development scenario (see Chapter 5 by Kato and Tokuda). SSC aggregates ODA-like flows to developing countries from emerging economies not included

4 See Chapter 2 in this book (by Serge Tomasi).
5 All values are reported in constant 2012 US dollars.
6 The World Bank, among others, uses this definition.
7 Our calculation from OECD data.

in the OECD-DAC list of donors. It maintains similar features in terms of concessionality (and therefore similar services costs to the recipients), but differs from ODA in some respects. Politically, Southern countries emphasise their difference from DAC donors. They promote the model of partnership, and refuse the standard donor-recipient relationship (the concept of ownership is indeed very important). Hence, they often reject the ODA definition used by DAC donors. The principle of South-South solidarity and non-interference in national policies are the main drivers of funding decisions. The modalities of aid provision from emerging donors tend to differ from the traditional ones, and are more likely to be focused – as exemplified by the case of China – on the provision of large-scale loans and big infrastructural projects, allowing partner countries to channel these resources to the productive sectors of their economies.[8] In addition, while ODA is often characterised by a vertical approach whereby donors exert tight control over the aid (conditionality), South-South cooperation seems to be driven more by the principles of a demand-driven approach. Emerging donors also engage in in-kind contributions (i.e. the exchange of skills and best practices), particularly through South-South triangular partnerships (in which an international agency or a country from the North supports the South-South cooperation). In addition, peer learning and knowledge-sharing, experience-sharing and technology-sharing are widely used by emerging donors (as illustrated, for instance, by the Africa-Brazil Cooperation Program on Social Protection). Much less South-South cooperation is directed at the financing of other public goods, such as social services and environmental protection.[9]

Domestic resources, that is, the capacity to generate domestic resources to be allocated to socially productive investments within the country. Mobilising domestic resources is by far the best way to reduce aid dependency and ensure long-run sustainability and domestic control in the provision of services and public investments. Furthermore, the ownership of the development process is likely to bring about a more conducive environment for foreign and domestic private investment, therefore triggering a multiplying process. Some countries, especially those in situations of fragility and conflict, lack the capacity to efficiently manage their fiscal systems and are constrained in a low-saving/low-investment trap (Aryeetey, 2009), even if there have been improvements in their capacity to obtain tax revenues (Chambas *et al.*, 2007; OECD, 2013a). Amongst domestic resources, taxation is of utmost importance, but in some countries most taxes still derive from import tariffs. Many developing countries are revising their tax policies and improving implementation, in particular through more progressive taxation and paying attention to their gender impact.

8 For a more detailed discussion on the China's contribution to development cooperation see Chapter 3 in this book (by Justin Yifu Lin and Yan Wang).

9 For a more detailed discussion about SSC see Chapter 4 in this book (by Debapriya Bhattacharya), and see Chapter 5 (by Hiroshi Kato and Masato Tokuda) for a discussion of triangular cooperation.

Private flows at market terms. Private investments from different sources have recently been the centre of attention in the debate on development finance, as demonstrated by the literature emphasising the positive spillovers generated for local economies and society as a whole. Private flows can contribute significantly to lowering public resource constraints. In this category, the DAC includes flows for commercial reasons from the private sector of a donor country, such as foreign direct investment (FDI), bank loans, and the purchase of developing country bonds or securities by companies or individuals in donor countries. In the last few years, private capital has been increasingly directed to developing countries, which in 2010 – and partly thanks to the expansion of global value chains – received for the first time over half of total flows. While FDI can create jobs and improve access to technology and markets, it is sometimes associated with negative effects, such as special rights for foreigners to acquire large areas of land cheaply, leading to the expropriation of peasants and/or to the loss of complementary resources, such as water. Given the absence of land registry and of clear rules and contracts in many countries, some governments allow or even promote land-grabbing as an easy way to raise funds from foreign investors. In other cases, FDI may induce environmental damage or lead to the unsustainable exploitation of natural resources (e.g. tropical rainforests). These examples suggest that there may be tradeoffs and not always complementarities between obtaining quick funding and achieving sustained development.

Philanthropy. A consistent source of development finance originates from non-governmental organisations (NGOs) and philanthropies, which tend to concentrate their funds on specific social programmes (e.g. focusing on health and education), putting a global emphasis on developing countries' needs. The growth of private philanthropy may be driven by the perception that non-governmental assistance is more effective than government aid in promoting development (Kaiser Family Foundation, 2012). Few studies exist on the quantitative estimates of these funds and their impact, or on their complementarity with other private and public sources. However, financing for agricultural seeds by the Rockefeller Foundation (which dates back to the 1960s and 1970s), the more recent large contributions of the Bill and Melinda Gates Foundation to agriculture and health, and the Soros Foundation funding for social tasks, among others, have contributed to development finance and have also shaped a more results-based approach to it. The underlying idea is that philanthropy can complement government funding: while governments may be good at finding 'a few likely winners, philanthropy is good at supporting a lot of possible winners, increasing the odds that someone will find new solutions to any given social problem' (Primorac, 2012).

A closely linked concept is that of *social enterprises***.** This is a relatively new concept but, according to the Global Entrepreneurship Monitor,[10] the practice is widespread. For developing countries, funds channelled by social enterprises

10 http://www.gemconsortium.org/.

such as the Grameen Bank have been important and have been often considered ‘impact investments’.[11] Social entrepreneurs bring an innovative portfolio of potential solutions to development problems. They tend to be flexible and experiment with new ideas, and they keep costs and risks low by starting on a small scale, and then scaling up their projects.

Sovereign wealth funds (SWFs) are owned or controlled by sovereign states (although separate from central banks), which invest all or a part of these resources (collected through trade surpluses or natural resources) outside of their national territory (Guérin, 2013). Although this form of external finance has existed since the 1950s, the recent shift of SWFs towards long-term proactive investment strategies and the increase in their number and scope has attracted particular attention. According to the SWF Institute,[12] SWF assets under management reached US$7 trillion in November 2014, with 60% coming from oil and gas-related exports. The increase of these funds is largely explained by rising commodities prices (supported by a sharp increase in global demand) and new discoveries of resources. The role played by emerging economies in SWFs is predominant: apart from Norway’s sovereign wealth fund, none of the eleven largest SWFs is from an OECD country. In addition, the newly established SWFs are being set up by new actors – especially resource-rich developing economies – that are rapidly achieving a prominent role in the global economy. Given that in the post-2015 development agenda a substantial effort would be needed to mobilise and channel institutional investment towards poorer countries, ODA could have a novel role to play: helping developing countries which are able to set up SWFs, in particular rich-resources countries, by providing strategic and technical support and expertise on the governance of SWFs (management, investment selection rules, partnerships with private sector or IFIs, consistency with macroeconomic policy, etc.). The recent emergence of SWFs with domestic investment mandates indeed represents a shift of emphasis in the role of natural resource rents in development towards domestic investments. Many sovereign funds, including some that traditionally were profitably investing abroad, have recently acquired some specific mandate to invest in infrastructures and other domestic domains. Though a lot remains to be understood about their processes and activities, and also in the light of recent raw material price developments, the picture that emerges highlights SWFs as an increasingly important source of development finance.

11 For a more detailed discussion about impact investment, see Chapter 20 in this book (by Jean-Michel Severino and Pierrick Baraton).

12 http://www.swfinstitute.org/fund-rankings/.

Box 1.1. *Sovereign wealth funds*

There is no agreed definition of what exactly a sovereign wealth fund is, nor how they operate. However, data suggest that most SWFs evolved from funds set up by governments whose revenue streams were dependent on the value of a specific commodity. Most SWFs have indeed been established in countries that are rich in natural resources, with oil-related SWFs being the most common and most significant. The governments of resource-rich countries did not want to be at risk of large fluctuations in prices and wanted to stabilise revenues. Their idea was to diversify investments, and this could be done with SWFs. Data and information on SWFs is still scarce (see http://www.ifswf.org/pst.htm for some case studies and reports on the working of some funds). An important actor in the framework of SWFs is Nigeria, the largest producer of oil in sub-Saharan Africa, which in 2011 set up a sovereign wealth fund managed by the Nigeria Sovereign Investment Authority (NSIA). This fund (which substitutes the Excess Crude Account created in 2004 and was endowed with US$1 billion from the Nigerian government) is intended to invest the savings gained on the difference between the budgeted and actual market prices for oil to earn returns that would benefit future generations. More precisely, the fund is composed of three different 'pools', each with a specific objective: a Stabilization Fund aimed at absorbing shocks; a Future Generations Fund aimed at long-term investments; and a Nigerian Infrastructure Fund to secure investments in important sectors of the economy, such as agriculture, power, transport or health care (Divakaran and Colford, 2014; Gelb et al., 2014).

Despite the large increase in recent years, with more than 20 newly established SWFs since 2005, several recent contributions on SWFs in developing countries suggest that there is still huge potential of this form of development finance. Divakaran and Colford (2014) argue that – *if wisely managed and well governed* – SWFs can be expected to play an increasingly important role in the coming decades and could emerge as a key driver of global development, since they are a way to provide development finance for countries often still at the margins of the international markets. However, according to the authors, 'SWFs in resource-rich low-income countries face challenges of governance and transparency that can inhibit their ability to contribute to and realize returns on investments in long-term development projects'. Indeed, Collier (2012) points out that, unlike most other sources of domestic revenue, the revenues from the depletion of non-renewable natural resources are likely to be unsustainable and volatile; hence, the debate should focus on how much should be saved and invested to ensure long-term fiscal and economic sustainability rather than consumed when realised, and on whether SWFs should invest in domestic infrastructure or if a part of the windfall should be transferred to citizens rather than all being spent by the state. Furthermore, the most appropriate types of longer-term investments have to be identified.

Box 1.1. *contd.*

For several years, SWFs have been looking to investments in emerging markets to diversify their portfolios and increase their revenues through higher returns. The portfolio optimisation of sovereign funds in developed countries as well as in emerging economies – based on risk-return and investment-horizon profiles – often led to investments in long-term development projects in emerging foreign markets. In fact, the largest share of SWFs (80% of the total) is invested in Asia, Africa and the Middle East, while only 20% is invested in Europe and the Americas (as of November 2014).[13] More recently, however, as pointed out by Gelb et al. (2014), an increasing number of SWFs are invested domestically, notably because of a '*persistent infrastructure financing gap in developing countries*'. A weak financial infrastructure and more generally a risky investment environment (heavy bureaucracy and controls, corruption and poor governance) are preventing an even greater share of SWFs or institutional investment from reaching developing countries, and are prompting many governments to encourage the newly established SWFs to invest increasingly in domestic industries and infrastructure projects. This culminated in a recent trend towards including domestic investment as part of the mandate of SWFs; recent examples include the Nigerian Sovereign Investment Authority, and the Fundo Soberano de Angola (Gelb et al., 2014). For many resource-rich developing countries that do not yet have access to global capital markets or are only now emerging onto the global economic stage, revenues from natural resources channelled through SWFs can provide an important mean to finance investments, especially in public goods such as education and infrastructure.

13 Among the most notable examples are Temasek's holdings in India's ICICI Bank and Tata Sky, the Kuwait Investment Authority's profitable investments in China's ICBC, the Abu Dhabi Investment Authority's holdings in Egypt's EFG Hermes and Malaysian land projects, and the Dubai Investment Corporation's stakes in North African companies like Tunisia Telecom (Gelb et al., 2014).

Remittances. Remittances by migrants currently total over US$500 billion, an amount larger than ODA flows, at the global level. According to World Bank estimates, the share of remittances sent to developing countries has been predominant and rather stable over the last couple of years (76% of the total stock in 2013 and 75% in 2014). To stress even further the importance of this form of finance for developing economies, it is worth looking at it as a share of national GDP: as reported by Docquier and Machado (see Chapter 12 of this book), remittances in 2010 accounted for more than 20% of national GDP for some emerging economies such as Tajikistan, Moldova, Lesotho and Kyrgyzstan. In addition, the authors' quantitative exercise reveals that remittances will remain a sustainable source of funding for low-income countries – the average ratio of remittances to GDP could be multiplied by a factor of between two and six by 2100. Given these figures, understanding the extent to which remittances are a development finance instrument is an important part of the development

discourse. For instance, there is some evidence of increased investments financed by remittances and of complementarities with other sources. It is worth exploring the extent to which allowing more immigrant workers into Europe and other donor countries could increase remittances to developing countries and gradually lead to a reduction in ODA. A possibly more realistic option is to examine how ODA can be used to better mobilise, transfer and use the remittances, for instance by lowering the costs associated with the transfer of remittances.

In what follows, we analyse the relative importance and developments over time of some of the above-mentioned forms of financing development and try to highlight complementarities across the different sources, while also accounting for the fact that each of them has specific objectives and built-in incentives.

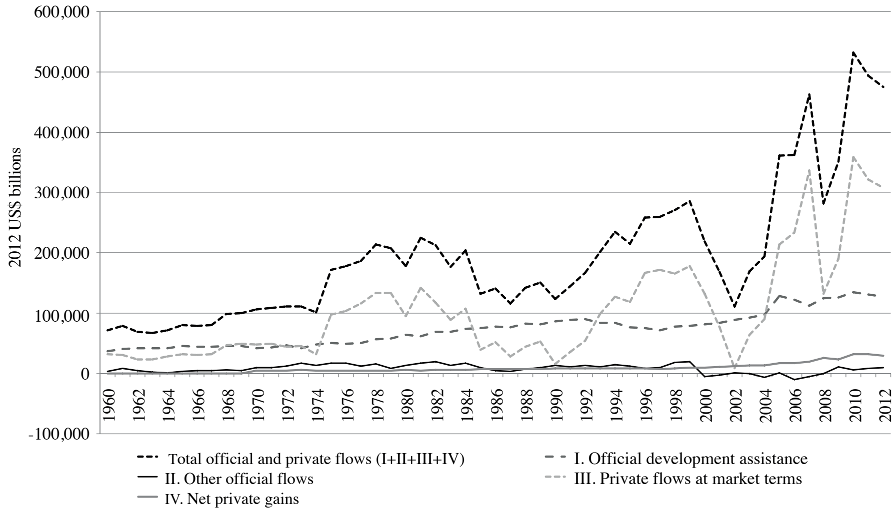
2. Changes in the financial landscape

Over the past ten years, the landscape of development finance has changed dramatically (United Nations, 2014). While ODA increased by 63% in real terms over the past decade and is still the main source of development finance for many countries, its relative importance has diminished and other forms of external finance – mainly private flows at market terms and remittances by migrant workers – have gained in prominence.

Figure 1.1 reports the trend over time since 1960 (in net disbursements) of the main four categories of total external flows reported by the OECD-DAC: (i) official development assistance, (ii) other official flows, (iii) private flows at market terms, and (iv) net private grants.[14] The figure refers exclusively to outflows from DAC members and the multilateral organisations to which they primarily contribute. Since DAC members provide approximately 95% of all external flows in the categories listed above, the trends reported can be considered significant. The figure shows that net disbursements of ODA have been steadily growing, though at a low rate, since 1960, while the trend for private flows has been much more volatile. Since 2005, the net disbursements in private flows at market terms have been at least twice the size of ODA, and for the last three years reported were more than three times greater.

14 DAC statistics do not include (i) transfer payments (e.g. pensions, workers' remittances) to private individuals, (ii) grants and loans for military purposes, or (iii) loans repayable within one year.

Figure 1.1. *Aggregate official and private flows: ODA vsersus other sources (in 2012 constant billion US dollars)*



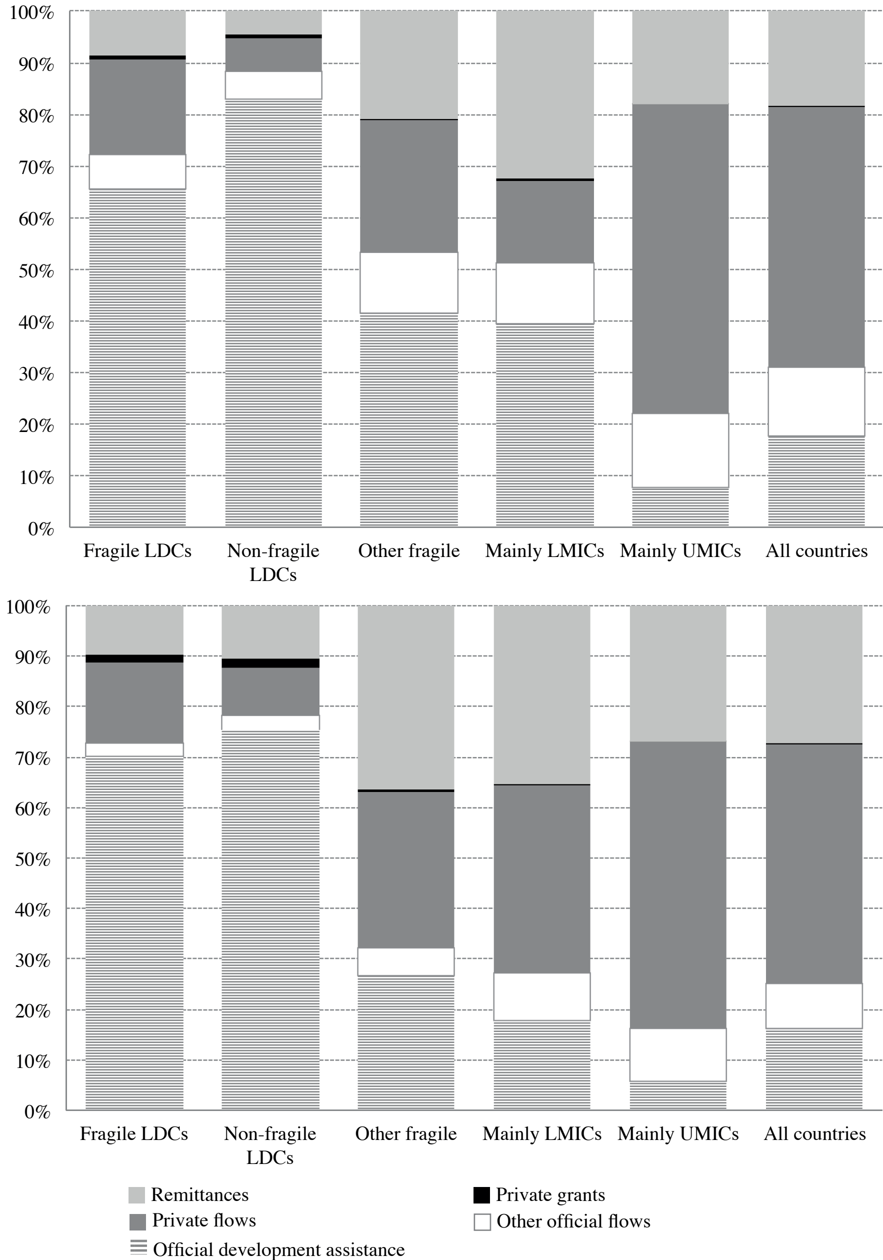
Notes: The categories follow the classification proposed by OECD and available at http://stats.oecd.org/# (last accessed January 2015). 'Private flows' consist of flows at market terms financed out of private sector resources (i.e. changes in holdings of private long-term assets held by residents of the reporting country) such as FDI, private export credits, securities of multilateral agencies, bilateral portfolio investment and others. 'Net private grants' or simply 'Private grants' is defined by OECD as grants by non government organisations (such as philantropic foundations and NGOs), net of subsidies received from the official sector (see http://stats.oecd.org/glossary/detail.asp?ID=3803). 'Total official and private flows' (I + II + III + IV) is the exact sum of the other four categories. The composition of these macro-categories according to OECD classification is described in Appendix A.

Source: All data are from OECD-DAC statistics.

However, as illustrated by the OECD (2013a), the recent increases in private flows have been mainly driven by investments in the forms of FDI, bank loans from market-raised funds, bonds and securities towards more creditworthy middle-income economies. Despite the large increase of external flows other than ODA over the last decade, the capacity of least developed countries (LDCs) to attract private flows remains very limited. Our calculation from OECD (2013a) data indicates that 'fragile LDCs', 'non-fragile LDCs' and 'other fragile categories' were able to attract around 2.71%, 0.49% and 6.20% of the total private flows in 2011 (excluding remittances), respectively. In contrast, middle-income countries – both lower (LMICs) and upper (UMICs) – attracted around 11.6% and 78.9%, respectively, of the total amount.[15]

15 We refer to the same group classification as that adopted in OECD (2013a) and OECD (2014b).

Figure 1.2. *External resources*



Notes: From 2005 onwards, private grants are based on estimates from the Hudson Institute's Centre for Global Prosperity, which uses a more generous definition than DAC statistics, including, for example, the imputed value of volunteer time.

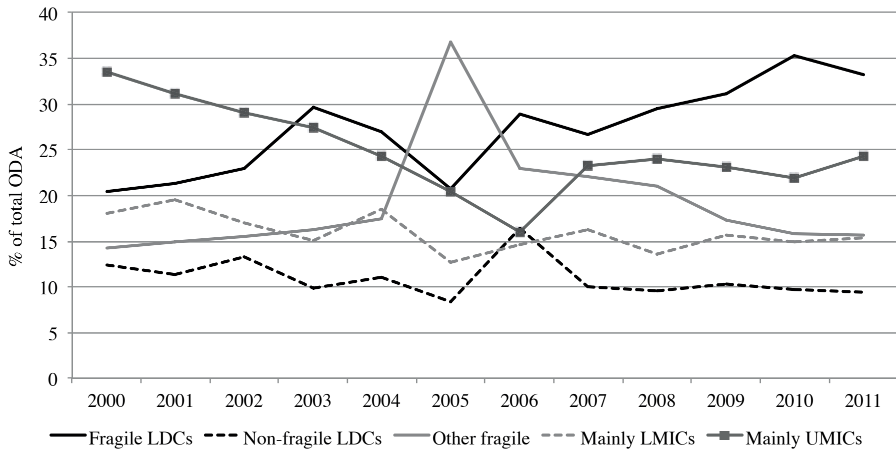
Source: Authors' elaboration from OECD (2014b), Figure 2.4.

In LDCs and other fragile economies characterised by high risk and extreme poverty, ODA therefore remains the largest share of external finance. As shown in Figure 1.2, ODA accounted for around 70% of all external financial resources for LDCs in 2011 (OECD, 2014a). Furthermore, ODA inflows account for relevant shares of GNI and are significant compared to the amount of resources that these fragile economies are able to mobilise domestically, for example through taxes. The OECD (2013a) reports that for fragile LDCs, net ODA inflows constitute less than half of government tax revenues and slightly less than total government expenditure and revenue. In contrast, as shown in Figure 1.2, for LMICs and especially UMICs, ODA is becoming much less important in relative terms compared to remittances, FDI, private domestic finance and public domestic revenues. Also as reported in OECD (2013a), for UMICs, ODA accounts for 6% of total external finances and represents only 0.8% of total tax revenues.

Regardless of the cross-group differences in terms of aid dependency, financial needs and creditworthiness, according to OECD estimates ODA to LDCs declined by 13% in real terms between 2011 and 2012 (OECD 2013a). In addition, the recent growth of ODA appears to be unevenly distributed according to countries' financial needs. Figure 1.3 reports the share of total ODA directed to each of the OECD (2013a) group over the period 2000-2011. The shares of fragile LDCs, non-fragile LDCs and the other fragile category of total ODA decreased over the last years, whereas the corresponding share for UMICs rose significantly.

Furthermore, the characteristics of ODA flows across country groupings have changed and diverged significantly in the last two decades (OECD, 2014b). LDCs have increasingly received ODA in the form of grants: the OECD (2013a) shows that fragile and non-fragile LDCs receive more than 80% of total ODA in the form of grants. LMICs and UMICs, instead, only attracted around half of their ODA in the form of grants; the remaining substantial part of ODA arrives in the form of loans, which represented more than 40% of their gross ODA in 2012 (OECD, 2014b). A large share of these loans received in recent years and reported as ODA has been provided by DAC donors from funds raised on financial markets and then lent at higher interest rates (OECD, 2013a).

Figure 1.3. *ODA flows by group*



Notes: The groups' classification follows the one proposed in OECD (2014b), Figure 2.2. The list of countries in each group category is presented in Appendix B. From 2005 onwards, private grants are based on estimates from the Hudson Institute's Centre for Global Prosperity, which uses a more generous definition than DAC statistics, including, for example, the imputed value of volunteer time.

Source: Authors' own calculation based on data from OECD (2014b), Figure 2.2.

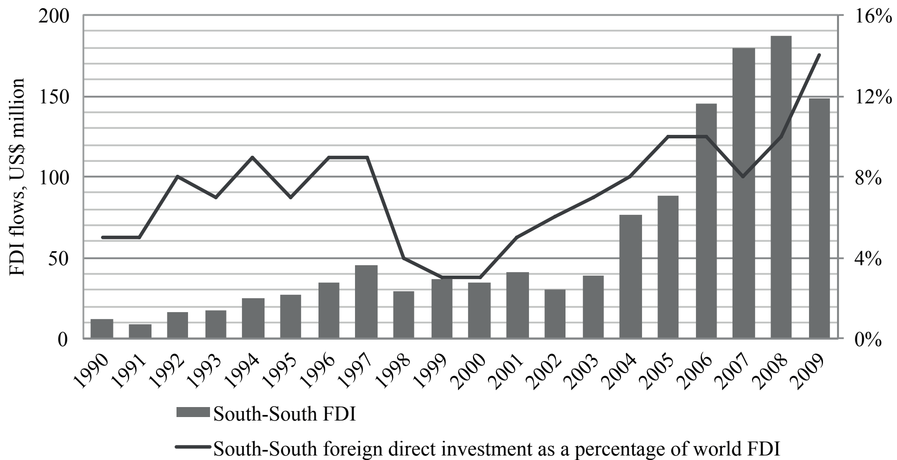
As mentioned above, the role of emerging donors is growing rapidly and they will become an increasingly significant source of global public and private international financing to developing countries. Over the past decade, the high economic growth rate of the BRICS[16] provided opportunities for greater integration with other emerging economies; for instance, the OECD (2014b) reports a substantial increase in South-South FDI. As Figure 1.4 shows, South-South FDI increased at an average annual rate of 21% between 1990 and 2009. The data indicate that total South-South FDI passed from a mere US$12 million in 1990 to US$149 million in 2009. While the overall figure in comparison to world outward FDI remains relatively small (at around 13%), these funds have become increasingly relevant for promoting economic growth in Southern economies (OECD, 2014b).

Aggregate official and private financial flows from emerging donors to the DAC list are currently not included in the official OECD-DAC statistics, and therefore there has been to date only limited detailed analysis of their actual amount and allocation patterns. Furthermore, the BRICS tend not to report the same type of information as DAC donors; for instance, they do not provide levels or the geographical focus of their financial flows. Finally, given the lack of uniformity in the measurement of South-South cooperation across countries, the challenges of monitoring and categorising, and the different methodologies/criteria adopted in the conversions into ODA-like flows, make it difficult to establish the exact volumes. However, the role of BRICS in development assistance, partnership

16 Brazil, China, India and South Africa.

and cooperation has certainly increased global development financial flows (OECD, 2014b). South-South cooperation is progressing both quantitatively as well as in terms of the sources of finance. Estimates of gross ODA-like flows from the BRICS range from US$3.2 billion in 2010 (OECD-DCR, 2013) to US$16-19 billion in 2011 (UN-ESC, 2014), which approximately correspond to 11% and 13.5%, respectively, of total ODA flows from DAC countries.[17] Di Ciommo (2014) claims that development cooperation from the South amounted to US$16.8 billion in 2011, representing 10% of global gross official assistance for development (DAC and non-DAC providers combined), the largest share since 2000.

Figure 1.4. *Growth in South-South foreign direct investment*



Source: OECD (2014b).

All estimates agree on China as being by far the largest provider (around US$5.5 billion in 2011) and Saudi Arabia the second largest (US$5.2 billion); together, they account for about 60% of total SSC. Qian (2014) argues that annual Chinese ODA rose almost six-fold from 2000 to recently. Kitano and Harada (2014) compute an accurate estimation of ODA-like flows from China and compare it to those of DAC donors, and argue that China moved up from a position of 16th in their ranking of ODA donors in 2001 to 6th in 2012 and 2013, with a level of bilateral aid that is approaching that of France, while multilateral aid has been estimated to be relatively small. They conclude that China's foreign aid is expected to rise rapidly to the level of the top DAC donors in the coming years. According to the Institute for Applied Economic Research, Brazil took part in technical cooperation with 99 countries in 2010, particularly in Latin America, the Caribbean and sub-Saharan Africa (IPEA, 2014). Between 2005 and 2010, the amount for technical assistance, aimed at training individuals and strengthening organisations and institutions abroad, increased significantly from

17 Our calculations using data from OECD-DAC.

US$16 million to US$58 million. The underlying motivation is the sharing of national knowledge and technologies. Along the same lines, Brazil also engaged in educational cooperation (US$36 million in 2010).

3. The ODA debate

Despite the fact that ODA represents the most important source of external financing for many developing countries, it falls short of the estimated needs of financing the new development agenda, which, due to its ambition, requires a very large amount of funds. Qian (2014) shows that, in the aftermath of the economic and financial crises of 2008-09 and the (still unsolved) debt crisis in Europe, only seven countries reached the established threshold of 0.7% of their GNI going to developing countries. Furthermore, ODA is under tighter scrutiny from donors because of budget cuts, and it is likely to be reduced in the near future.

In addition to not being sufficient to meet the global challenges, the resources are also not well distributed – as mentioned above, LDCs, which are more in need, receive a very small share of the total flows. According to a number of studies, it is mainly the strategic concerns of donor countries rather than the actual needs of the recipients that drive foreign aid (Alesina and Dollar, 2000; Qian, 2014; Nunn and Qian, 2014).

Furthermore, all ODA is not alike and the effectiveness of aid is likely to depend on its type, the way it is delivered and its target. For instance, the UNDP (2011) argues that foreign aid measured at the aggregate level encompasses large amounts of development aid – such as the costs of hosting refugees or the costs of educating foreign students – that never actually reaches developing countries and the effectiveness of which as ODA compared to other instruments has been questioned by some analysts (Roodman, 2014).

Lastly, the OECD (2014b) emphasised that, especially for fragile countries, ODA should be used to enhance synergies with domestic resource mobilisation and to create an environment that is conducive to investments. More precisely, the idea, beyond exploiting the existing positive externalities, is to share risk between the public and private sectors, which is particularly important in situations of uncertainty and fragility.

To address all of these issues and in response to the significant changes in the nature of development finance flows in recent years, donors are *revisiting* the definition of ODA for the post-2015 period with a view towards the following.[18]

1. Broadening the measure of development finance to include resources beyond ODA.[19] The recent debate focuses on (i) the inclusion of leveraging instruments such as non-concessional lending, equity, blended finance,

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18 For a more detailed discussion on the new proposals under scrutiny by DAC, Chapter 2 in this book (by Serge Tomasi).

19 On the changes in the concept of ODA since its inception, see Boussichas and Guillaumont (2014). The authors address several related and relevant questions in discussing whether the financial terms of a flow can justify it being considered ‘aid’, i.e. whether the purpose of the flows justifies the definition of development aid, and also deal with the issue of which countries are eligible for ODA.

loan and investment guarantees and other risk-sharing mechanisms that help to mobilise private investment for development and stimulate the recipients' private sector; and (ii) officially recognising the contribution to addressing conflict and fragility of a wider range of security-related spending (OECD, 2013a). In line with this trend of reforms, the DAC is proposing to introduce an alternative measure beyond ODA: Total Official support for Sustainable Development (TOSD). This broader and more inclusive measure of development finance aims at covering the totality of resource flows towards developing countries and multilateral institutions (both concessional and not concessional) originated from official sources and mechanisms. The components of this measure are still under scrutiny by DAC: the actual data collection is not expected to start before 2016 (OECD, 2014d).

2. Excluding from ODA those expenditures that never reach the developing country – namely, *support to students and refugees from developing countries* living in donor countries – and generally those expenditures with a relatively lower impact on development that do not reflect donors' efforts, such as *debt forgiveness* (OECD, 2013b).
3. Correcting the distortions that led to the current uneven distribution of ODA. The main proposals include (i) targeting LDCs with more aid both in terms of the ratio of ODA to national GNI and the total volume of foreign aid; and (ii) reducing the current DAC List of ODA Recipients by introducing a lower per capita income threshold. At the last DAC meeting in December 2014, members formally expressed a commitment to reverse the declining trend of aid to the countries most in need, reaffirming the specific UN target of between 0.15% and 0.20% of GNI as ODA towards LDCs. Members '*reaffirm their respective ODA targets, including those who have committed to the UN target of 0.7% ODA/GNI target and the UN LDC target, and reaffirm their strong commitment to achieve them*' (OECD, 2014d).
4. Redefining the conditions under which concessional loans can be counted as aid by counting only the grant element as ODA and adjusting the discount rate to better reflect current market conditions. With respect to this, at the last DAC High Level Meeting members opted for an assessment of concessionality based on a differentiated grant equivalent method and discount rates, consisting of a base factor – which will be the IMF discount rate (currently 5%) – and an adjustment factor of 1%, 2% and 4%, respectively, for UMICs, LMICs and LDCs-LICs. Furthermore, in order to incentivise lending on highly concessional terms to those countries most in need, loans to LDCs and LICs must have a grant element of at least 45% to be reported as ODA, while for loans towards LMICs and UMICs the threshold drops to 15% and 10%, respectively (OECD, 2014d).

4. Concluding remarks

With 2015 upon us and the debate on the post-2015 development goals still ongoing, the issue of financing development still presents many open questions. However, a consensus has been reached on the fact that the debate on the post-2015 goals cannot proceed independently of their financing and its implementation; establishing complex goals without properly addressing the means of financing and the ways of delivery is simply no longer credible.

The development landscape has changed substantially in the last decade with the increasing role of emerging donors, who have a different approach that is unconditional and based on an equal relationship and not on a standard donor-recipient relationship. The nature and size of flows have also changed. Private flows (remittances, foreign direct investments, funds from philanthropy, etc.) and public funds have been put under increasing scrutiny as far as their effectiveness is concerned. The sources for a sustainable financing of development now include mobilising domestic resources, mobilising external private resources, and improving development cooperation for sustainable development. But aid delivery mechanisms have also been scrutinised in order to maximise aid effectiveness, as the lively debate on budget support indicates. As a result, donors should vary their aid delivery mechanisms in different countries, according to their goals.

Against this background, the term ‘innovative finance’ for development has been widely used. The concept involves more than just identifying new sources of financing (both public and private) and/or harmonising DAC and non-DAC donor practices; it also aims at engaging new stakeholders, as well as involving local communities in the field (Baliamoune-Lutz, 2013). The Monterrey Consensus of the International Conference on Financing for Development in 2002 and its follow-up, the Doha Declaration on Financing for Development in 2008, have already highlighted the necessity of mobilising private (domestic and international) resources, such as taxes, FDI, remittances for development, including the need for ‘exploring innovative sources of finance’ (United Nations, 2003, p. 16).

While adequate financing strategies and commitments should be linked to specific goals and targets, partnerships between donors and recipients must remain a goal in itself, since they provide the vehicles to generate target-specific finance.

This chapter has reviewed these issues in an attempt to portray the state of the art. However, there is much more to be done. On the one side, the mechanisms through which externalities can be exploited should be better clarified. On the other hand, there is the problem, only partially addressed, of the countries in situations of fragility and conflict. The emphasis on these countries and on their need for funds seems to contradict the desire to allocate aid preferentially to ‘better performing countries’, since most of these countries have illegitimate governments or weak institutions. This contradiction can be overcome only by new principles of allocation, for example by taking into account the structural

vulnerability and the level of human capital of recipient countries (Guillaumont *et al.*, 2010).

From an economic perspective, this is a standard principal agent problem, where donors represent the principals and recipients represent the agents. Donors are in a situation of informational disadvantage. Recipient governments have a variety of interests, including maintaining diplomatic relations with donors, maintaining power or position in office, distributing favours, and enacting policy goals. Because donors do not know how recipients will use the funds, some implementation problems may arise. These problems are exacerbated for countries in fragile situations. There are moral hazard problems if the recipient government takes riskier decisions about how to use the funds, but asymmetric information is also associated with rent-seeking and increased corruption.

The current, lively debate aims at strengthening the integrity of the measure of ODA and there is a consensus on encouraging the use of ODA for mobilising more (public and private) resources for development, and their efficient spending. It is very important to enhance the positive externalities between different sources ,both in terms of flows and in terms of DAC and non-DAC donors.

Since the actual volume of ODA is far from sufficient to support the MDGs, and especially the more inclusive post-2015 development goals, there is agreement on introducing non-grant financial instruments – such as guarantees, mezzanine finance or equity – that need to be better valorised not only in the new measure of TOSD, but also within ODA. These measures have the potential to address the huge existing financial gap by leveraging significant additional (public and private) resources for development.

As mentioned above, a considerable share of ODA is spent within donors' borders. The *de facto* equivalence of these two types of assistance – both counted as ODA, but likely to provide very different outcomes – has been subject to criticism. The removal of in-donor expenditures might create incentives for rich countries to invest in more effective contributions to recipients, such as Country Programmable Aid (CPA). However, discussions at the DAC have indicated that *there is little appetite for removing in-donor costs from ODA* (OECD, 2014a).

While low-income and fragile countries will most likely continue to rely on ODA to achieve their development goals, and the issue of effective delivery will have to be solved, official financing is also insufficient to cover the financing needs of middle-income countries. Given the growth in trade and FDI, and the growing involvement of MICs in international markets, policy-makers in both partner and donor countries see an opportunity to raise additional funds from the private sector to help meet the financing needs of the development agenda. Public resources in developing countries are insufficient to cover all of the financing needs for investment, notably in infrastructure, public utilities, energy and other types of services. The key is to supplement these funds with private funding and to use risk-sharing mechanisms.

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Annex A: List of countries for each group according to OECD classification

UMICs	Fragile LDCs	Other Fragile	Non-fragile LDCs	**Mainly LMICs**
Albania	Afghanistan	Bosnia and Herzegovina	Benin	Armenia
Algeria	Angola	Cameroon	Bhutan	Bolivia
Anguilla	Bangladesh	Congo, Rep.	Cambodia	Cape Verde
Antigua	Burkina Faso	Côte d'Ivoire	Djibouti	Dominica
Argentina	Burundi	Egypt	Gambia	Georgia
Azerbaijan	Central African Rep.	Iraq	Laos	Ghana
Belarus	Chad	Kenya	Lesotho	Grenada
Belize	Comoros	Kosovo	Mozambique	Guyana
Botswana	Congo, Dem. Rep.	Libya	Rwanda	Honduras
Brazil	Eritrea	Marshall Islands	Samoa	India
Chile	Ethiopia	Micronesia, Fed. States	Sao Tome and Principe	Kyrgyz Republic
China	Guinea	Nigeria	Senegal	Maldives
Indonesia	Guinea-Bissau	Pakistan	Tanzania	Moldova
Iran	Haiti	Sri Lanka	Vanuatu	Mongolia
Jamaica	Kiribati	Syria	Zambia	Nicaragua
Jordan	Liberia	Zimbabwe		Papua New Guinea
Kazakhstan	Madagascar			St. Lucia
Lebanon	Malawi			St. Vincent and Grenadines
Malaysia	Mali			Tajikistan
Mauritius	Mauritania			Tonga
Mexico	Myanmar			Uzbekistan
Montenegro	Nepal			Viet Nam
Montserrat	Niger			
Morocco	Sierra Leone			
St. Kitts Nevis	Solomon Islands			
Suriname	Somalia			
Swaziland	South Sudan			
Thailand	Sudan			
Tokelau	Timor-Leste			
Tunisia	Togo			
Turkey	Tuvalu			
Turkmenistan	Uganda			
Ukraine	Yemen			
Uruguay				

Notes: The list of countries for each category is taken from OECD (2014b).

Annex B: Composition of Aggregate Official and Private Flows according to OECD-DAC

TOTAL OFFICIAL AND PRIVATE FLOWS (I+II+III+IV)

I. OFFICIAL DEVELOPMENT ASSISTANCE (I.A + I.B)
I.A. Bilateral Official Development Assistance by types of aid (1+2+3+4+5+6+7+8+9+10)
1. Budget support
2. Bilateral core contributions & pooled programmes & funds
3. Project-type interventions
4. Experts and other technical assistance
5. Scholarships and student costs in donor countries
6. Debt relief
7. Administrative costs not included elsewhere
8. Other in-donor expenditures
9. Recoveries on bilateral ODA grants / negative commitments
10. Other loans repayments
11. Other ODA not assigned to the above categories (historical series)
I.B. Multilateral Official Development Assistance (capital subscriptions are included with grants)
1. Multilateral contributions to:
2. Recoveries on multilateral ODA grants and capital subscriptions / negative commitments

II. OTHER OFFICIAL FLOWS
II.A. Other Official Bilateral Flows
1. Export-related transactions
2. Investment-related transactions
3. Debt rescheduling
4. Other bilateral securities and claims
5. Offsetting entry for debt relief
II.B. Transactions with Multilateral Agencies at Market Terms
1.Purchase of securities from issuing agencies
2. Other transactions

III. PRIVATE FLOWS AT MARKET TERMS
III.A. Bilateral Private Flows
1. Direct investment
2. Other securities and claims
3. Offsetting entry for debt relief
III.B. Multilateral Private Flows

IV. NET PRIVATE GRANTS
derived as: 1. Gross outflow from private sources, less
2. Support received from official sector
V.1. Total participation in peacebuilding operations (incl. non-ODA)

2

Modernising and Revitalising the Measurement of Development Finance

Serge Tomasi

Development finance is at a crossroads. In a global economy where the old North/South divide is giving way to new macroeconomic balances, savings accumulate in emerging countries while the OECD economies face structural budget and balance-of-payments deficits. Economically, the South is breaking up. New economic powers are becoming established and middle-income countries (MICs) have begun to take off. Other countries, however, (LDCs, fragile and conflict-affected countries) remain locked in the poverty trap, unable to meet the basic needs of their populations due to a severe lack of funding. Furthermore, these countries are often particularly affected by the threat to global public goods (climate change and loss of biodiversity, communicable and emerging diseases, etc.), which cannot be regulated without establishing ambitious programmes in middle-income and even emerging countries. As the international community gets ready to publish a new international cooperation agenda, it is essential to review the systems for measuring and tracking development finance, which are increasingly disconnected from economic reality. Having first briefly outlined the main shortcomings of the current system, I will propose a simple system that refocuses the definition of official development assistance as grants, and centres it on poor countries, while developing another, more comprehensive indicator of 'official development finance' that can better account for market instruments and lead to more efficient allocation of development finance.

1. A traditional measure of development finance focused chiefly on concessional aid, which fails to reflect recent economic upheavals and the diversification of the international cooperation agenda

Development cooperation was born after World War II. Europe, devastated by conflict, had to be rebuilt, and the major multilateral institutions, such as the OEEC (which preceded the OECD), the World Bank and UNICEF, were created at the time to manage reconstruction aid. Yet it was with the decolonisation movement of the late-1950s that a full-blown 'aid architecture' was set up, growing steadily more complex over time. The major multilateral agencies saw their mandates redirected towards 'third world countries', while the major industrial powers begin to structure policies for bilateral cooperation. Together they formed the Development Assistance Committee (DAC) in 1960, a few months before the

OECD. From the beginning, the DAC's mandate was to record and monitor statistics on financial flows for development to poor countries, and to share best practices. However, it was not until 1969, when the General Assembly of the United Nations requested a target be set for the financial commitment to development, that the DAC adopted a definition of official development assistance (ODA) that has hardly changed since.

1.1. A definition of official development assistance centred on the principle of concessional aid to poor countries, which measures the 'budgetary' effort of donor countries

ODA is defined by three basic criteria:

- *Official flows*, i.e. from a public authority (state, agencies or local authorities).
- *Official and concessional flows*, i.e. that respect a minimum concessionality level defined as having a grant element of 25% calculated at a rate of discount of 10%.
- *Official and concessional flows for development*, i.e. allocated to finance expenditure that promotes the economic and social development of developing countries, which are defined as such by the DAC based chiefly on average per capita income.

Over the period 1960-2012, global ODA has increased in volume but donors' comparative effort (ODA/GNI) has fallen.

The volume of global ODA has grown steadily over the last 50 years, from just under US$40 billion in 1960 to around US$134.8 billion in 2013, a historical record (see Chapter 1 in this book). Over the last decade, it rose in volume yet again by 63%.

The number of donor countries has increased, as some former beneficiaries have become donors. Korea, for instance, progressed from a low-income country (LIC) in the 1960s to 16th out of the 29 DAC donors in terms of volume in 2012. Finally, global income has risen considerably, especially in the industrialised countries, eroding ODA in relation to gross national income (GNI), which fell between 1970 and 2012 from an average of 0.51% to 0.28% for DAC members.

Continuity with regard to ODA accounting rules is reaching its conceptual and operational limits

This definition of ODA has remained largely unchanged since, which has helped ODA flows to be monitored consistently over a long period. Its essence was to measure the 'budgetary effort' of donor countries, promoting peer pressure and tracking net flows.[1]

Half a century later, ODA is plagued by recurrent, growing, and more or less well-founded criticism. Part of the criticism is directed towards the list of eligible expenditure. Some observers see this list as too permissive, in that, for instance, it includes expenditure that does not result in financial flows towards developing

1 ODA is measured in net flows, i.e. payments made by a donor country in year *n* minus any repayments received for past loans.

countries (for example, accepting refugees or students from developing countries in donor countries). Others find it too restrictive, as it largely excludes security expenditure, even though the link between security and development is widely acknowledged and an increasing number of the countries that are lagging in terms of their achievement of the MDGs are countries in conflict or crisis recovery.

Also criticised is the measure of ODA which, by concentrating on budgetary effort, is overly focused on the donors' perspective. Little weight is given to the recipients' perspective, which is primarily concerned with the volume and/or cost of the resource (a loan with no direct budgetary cost is still economically effective if it gives the borrowing country access to a cheaper and/or more readily available resource than that provided by the market, particularly for investments with high economic and social returns). As such, it neglects market instruments, which are in fact essential for financing the growth necessary for economic development. It may even create negative incentives. For example, public guarantees on private loans are only recorded as ODA if the guarantee needs to be called upon, thereby rewarding projects that fail, and ignoring the value of private funds raised when the investment is successful.

In any event, the measurement of donor efforts has been the subject of intense debate between the DAC member states for the last decade. Indeed, the rate of discount used (10%) to calculate the grant element of loans, which has been the same since the 1970s, seems very generous in light of current financial market conditions. It allows a bilateral donor to declare loans with no direct budgetary cost (i.e. with no government interest rate subsidy) as ODA, thanks to the low cost of borrowing capital on international markets and the favourable conditions of on-lending to developing countries (extended life of the loan, grace period granted).[2]

Another highly perverse effect of the current system is that in a period of fiscal stress, when states are struggling to meet their commitments on ODA volumes (the famous 0.7%, for example), it rewards the use of the least concessional instruments that, with a low budget effort, can generate a maximum of ODA through short-term leverage.[3] Consequently, the system creates a disincentive for programming grants. Significant distortions in the geographical allocation of aid may result, as poor countries are often not eligible for loans, or the least concessional loans in any case. This distortion has certainly played a part in developments of recent years, which have seen a slowdown or decline in programmable ODA to LDCs combined with an increase in the volume going to MICs, including the highest income MICs.

Finally, such a system undermines the optimal management of aid agencies, as they may be encouraged to select a financial instrument based on its ODA eligibility and not solely on the type of investment to be financed.

2 The system also has the unfortunate drawback of creating a major distortion between bilateral and multilateral aid, since a loan granted by a multilateral bank must be accompanied by a grant to be declared as ODA.

3 As ODA is calculated as a net amount over the life of the loan, the loan produces no ODA other than the grant element included in it.

Clearly, the current measure of development finance, largely centred on concessional assistance through the ODA concept, has many limitations. The definition is complex, the range of eligible expenditure is subject to debate as cooperation priorities evolve, and the concept is not conducive to financial innovation. It may even curb the mobilisation of additional concessional revenue and create a disincentive to develop mechanisms that might catalyse private investment.

Last but not least, the focus of international debates and accountability processes on the measure of ODA effort alone discourages discrimination between instruments for financing development. Yet such discrimination is essential for dealing with the diversification of developing countries' economic trajectories and with an increasingly complex international cooperation agenda.

1.2. Current economic upheavals and the growing complexity of the international cooperation agenda make it essential to modernise the way development finance is monitored

Mobility of capital flows and the strong increase in private investment

The world is changing, swept along by dizzying economic upheavals. Cooperation policy must adapt to increasingly divergent economic trajectories among developing countries and to its own increasingly complex agenda. Taking advantage of the liberalisation of capital movements and the globalisation of the economy, including the emergence of global value chains, some developing countries now have ample access to private funding, made even more accessible by the liquidity of the global economy. It naturally follows that the share of ODA as part of total external flows received by developing countries fell overall from 50% to 24% between the late 1960s and the present. Besides foreign direct investment flows, other external flows such as migrant remittances (US$345 billion in 2012) are overtaking the volume of ODA (US$130 billion).

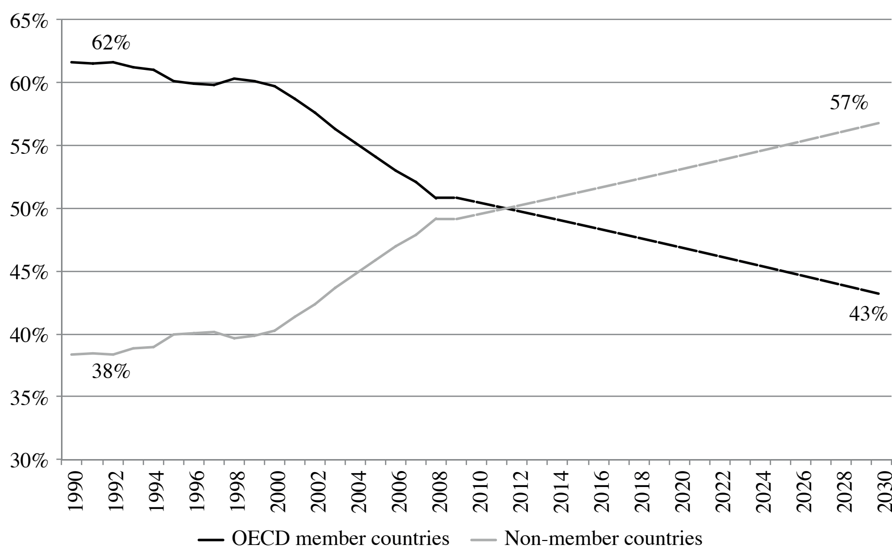
The diversification of developing countries' economic trajectories and emerging countries' economic success

Another major factor in the diversification of external finance sources is the significant economic progress many developing countries have made in the space of half a century. Since 1969, 55 countries have been removed from the DAC list of developing countries because of their economic take-off. Several countries are expected to leave the list in the coming years due to their increase in per capita income, including Chile in the short term and China in around 2020. Since 1990, more than 20 developing countries have moved from the category of low-income country to become middle-income countries. As a result, they have better access to financial markets and/or market instruments offered by development banks. The share of ODA as part of total external financial flows in these countries is naturally – and fortunately – decreasing.

Finally, certain developing countries have now emerged as economic powers of the first order. China is the second largest economy in the world in terms of GNP. Most of the global growth potential now lies in the large emerging countries, which also concentrate a growing share of global savings, while

OECD countries face sluggish economic growth and significant internal and external imbalances. The shift in global wealth is rapid and powerful and, as such, the issue of development finance, including its share in the fight against poverty, has to be rethought. There is an urgent need to extricate it from an ODA 'fetishism' in order to propose more diverse financing methods, better suited to the economic context of the recipient countries or the nature of the programmes to be funded. A universal system for monitoring development finance must also be developed, particularly in order to gain a more accurate picture of South-South cooperation flows, which are poorly evaluated at present.

Figure 2.1. *Share of the global economy, 1990-2030 (% of global GNP, in PPP)*



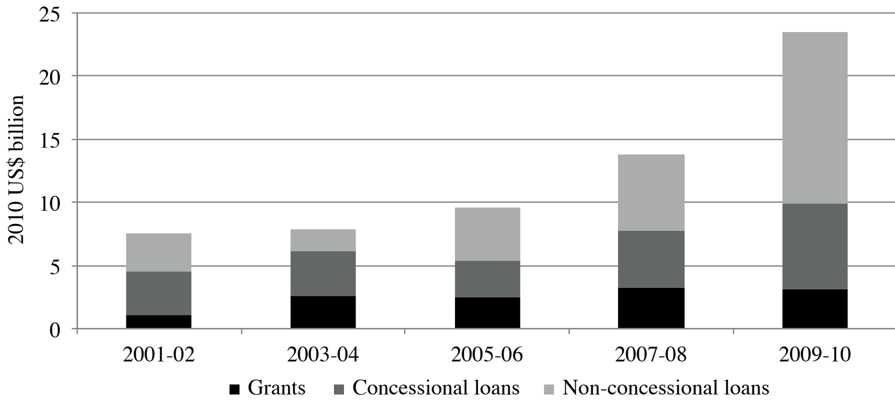
Note: These data apply Maddison's long-terms growth projections to his historical PPP-based estimates for 29 OECD member countries and 129 non-member economies. The dotted lines correspond to growth projections.

Source: Authors' calculations based on Maddison (2007, 2010).

The rise of global issues on the international cooperation agenda

Diversification of the international cooperation agenda is the final element that advocates for an overhaul of how aid is measured. Indeed, far from being limited to supporting the fight against poverty, development finance increasingly has to address the issue of global public goods. This means financing cross-cutting programmes, often localised in developing countries (the response to climate change and communicable diseases, promotion of food security, biodiversity conservation, and so on). Similarly, in view of demographic pressures, financing economic growth that creates more jobs and improving access to energy have again become top priorities, which can at least in part be financed with market instruments.

Figure 2.2. *Total aid to the energy sector: Grants, concessional and non-concessional loans*



Note: Average annual commitments, constant prices.

While aid to the energy sector has increased, the funding of energy-related projects under market conditions has risen even faster. The share of non-concessional capital contributions as part of total contributions to the energy sector was 58% in 2009-10, compared to 22% in 2003-04. These contributions mainly come from multilateral organisations.

Figure 2.2 shows both the importance of new issues on the agenda, in this case financing access to energy (the volume of funds allocated to energy having grown sharply over the last decade), and changes in the method of financing (the share of grants decreasing significantly in favour of market instruments).

The DAC has been trying to improve the measuring of development finance for several years. On the one hand, it has developed the concept of 'programmable aid', which aims to isolate the ODA that is subjected to *ex post* planning and a transfer of cross-border flows. On the other hand, it has supplemented ODA statistics by monitoring 'other official flows' (OOF). However, the system and the debate are still largely focused on the concept of ODA, which is unable to account for the diversity of needs and the range of financial instruments for development. At its December 2012 High Level Meeting, the DAC decided to initiate work to modernise the systems for monitoring and measuring aid, including, if necessary, a redefinition of ODA.

2. Modernising the system for monitoring development finance to capture all instruments and facilitate optimal resource allocation

The limits inherent in the current system for measuring aid and the changing economic landscape make it necessary to rethink the measuring of development finance around clear principles: (1) the definition of a simple and easily understandable mechanism that strengthens the legitimacy of concessional aid, which remains essential for poor and fragile countries; (2) a mechanism that also captures the diversity of financial instruments, creating positive incentives for diversification without causing any distortions in the selection of instruments; (3) a mechanism that better accommodates the recipient perspective (measure of volume, cost and quality of the resource); and (4) a mechanism that focuses concessional aid where it is most useful.

2.1. Creating a new, more comprehensive indicator for official development finance (ODF) that takes better account of developing countries' diverse economic trajectories and the range of financial instruments

This is the first vital step towards modernising how development cooperation financing is tracked and redefining ODA. The system must no longer focus exclusively on traditional ODA (i.e. the most concessional resources such as grants) if it is to monitor development finance more comprehensively and provide the necessary incentives for a diversification of instruments. This new indicator is key to adapting development finance to the diverse economic trajectories of developing countries, and thereby refocusing ODA (i.e. assistance in its most concessional form with the highest budgetary cost) on its natural target, namely the poorest countries.

This indicator would aim to capture total official external development finance, regardless of concessionality level. As well as grants, it would include concessional and non-concessional loans, cancellation of debt, equity and guarantee instruments. It could be extended to the financing of expenditures, beyond those programmes targeted at the economic and social development of the population, that are useful or essential, first and foremost security expenditure. It would measure gross flows rather than net flows, so that the entire volume of funding disbursed in a given year for a country and/or from a country can be

accounted for. In terms of guarantees, it would include, or at least indicate, the amount of private funding guaranteed in order to estimate its 'leverage'.[4]

The full inclusion and valuation of these market instruments, alongside concessional 'ODA' (see Section 2.2), could create positive incentives for increasing their use to (i) strengthen the mobilisation of private investment, (ii) fund infrastructure and other investments that support economic growth, and (iii) meet the growing needs of middle-income countries in their fight against poverty and the promotion of global public goods.

The new geography of poverty

Since the 1990s, the geography of poverty in the world has undergone a major shift. Whereas in 1991, 90% of the world's population living below the absolute poverty line was located in low-income countries, today more than two-thirds of this population lives in middle-income countries.

In 2010, as shown in Sumner (2010), extreme poverty occurred mainly in the MICs. That is largely due, on the one hand, to population growth and the size of the countries and, on the other, to the transition of many of those countries from LIC to MIC status over the past 20 years or so.

In terms of ODA allocation, particularly with regard to the goal of reducing absolute poverty, this trend presents a daunting challenge. Should the priority be to allocate aid according to the number living in poverty, i.e. to target poor populations, or according to the incidence of poverty, i.e. to target poor countries?[5] *Over 50% of the population of the LDCs lives below the absolute poverty threshold, and in some countries that proportion could be as high as 70%.*

For the first time in history, we have the means to eradicate absolute poverty. The goal of eradicating it by 2030, which should be at the centre of the post-2015 agenda, deserves to be upheld. Yet this goal must not be pursued to the detriment of poor countries, through the misuse of the most concessional aid. Therefore, the existing differences between developing countries, including their debt capacity and access to domestic, regional and international financial markets, must be taken into account more effectively in the allocation of official development finance. Funding for cooperation programmes in the MICs, especially the highest income MICs, should be primarily through finance that is

4 This type of instrument could also be useful to distinguish 'development aid' expenditure and expenditure on the response to climate change or to promote green growth models. Indeed, while the former is solely aimed at improving the economic and social conditions of the population of developing countries, the latter also concerns people in developed countries by limiting an increase in global CO_2 emissions and safeguarding global public goods. Yet funding for certain green expenditure, such as renewable energy, may, at least in the medium term, represent an unsustainable premium for poor countries that already face the challenge of expanding access to energy (as is the case for most African countries, where more than two thirds of the population have no access to electricity). It is possible to imagine a system where the minimum cost of expanding access to energy would be recorded as ODA. Such programmes generally involve conventional production methods. Instead, any additional cost involved in using sustainable production methods could be recorded as funding for climate change mitigation through this comprehensive indicator of 'development finance'.

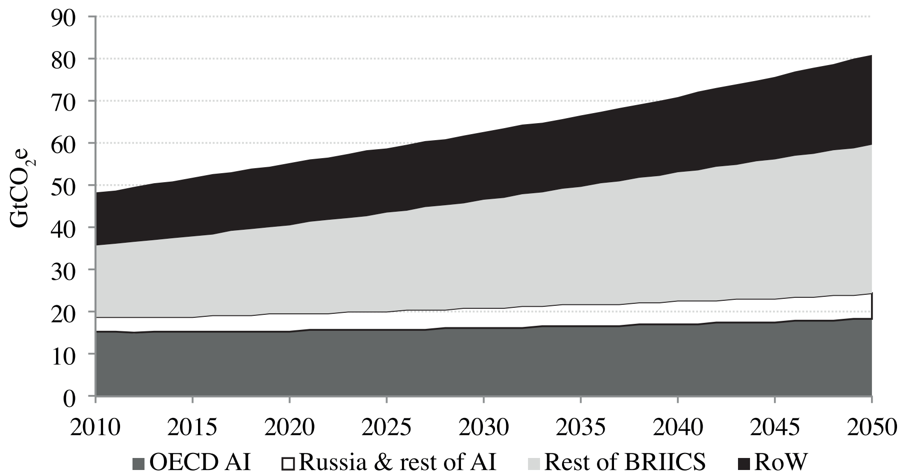
5 The incidence of poverty is defined as the proportion of the population of a particular country that is classed as poor.

not concessional, or only to a very limited extent, with the most concessional aid reserved for the poorest countries or those in crisis recovery.

As well as discriminating geographically, it is important to discriminate between the types of programme being funded. For too long, certain donors have financed the construction of infrastructure for transport, energy and climate change mitigation with concessional instruments or grants, when the use of market instruments would have been more judicious given the profitability of these investments. The change that has occurred in financing energy-related aid is a good example of a more efficient allocation of public resources. DAC recommendations should encourage these good practices.

It is the same for financing global public goods, which involves massive intervention in MICs, and even emerging countries.

Figure 2.3. *Climate change: 50% increase in greenhouse gas emissions by 2050*



Source: OECD (2011).

Figure 2.3 shows that, with no change in production and consumption patterns, greenhouse gas emissions could increase by 50% between 2010 and 2050, leading to an increase in the average global temperature compared to the pre-industrial era of well beyond the 2 degrees target agreed upon in Copenhagen. The emerging countries (in this case, the BRIICS) are likely to be the majority contributors to this global trend, whilst the share of total emissions from OECD countries would decline and that of the other countries, including LICs, would gradually increase.

As such, it seems natural for *mitigation* measures financed by foreign aid to focus primarily on the MICs and emerging countries rather than on LICs.

Figure 2.4. *Aid to combat climate change in 2011*

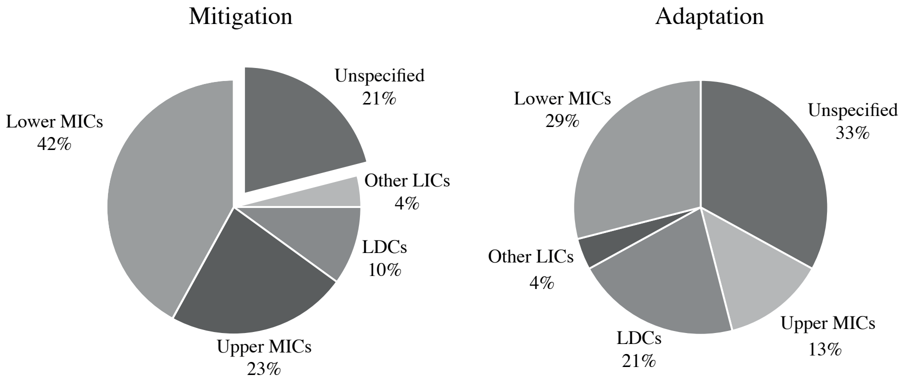


Figure 2.4 illustrates the differences in aid to combat climate change, measured by the DAC with the Rio markers. *Mitigation measures* (left-hand chart) are focused very much on MICs (65%), whereas LDCs, which have very low emissions, receive only 10% of the aid. A substantial share of the aid to mitigate climate change, defined as programmes targeted mainly at reducing greenhouse gas emissions, is directed at countries such as China (which has the highest gross emissions in the world, ahead of the United States) and Indonesia (fourth highest emissions). The allocation of *aid for adaptation* (right-hand chart), designed to minimise the impact of climate change on populations, is much more balanced, with LDCs receiving 21%. The share allocated to MICs falls to 42% of the total.

Consequently, an optimal resource allocation should lead the international community to favour non-concessional resources to finance the mitigation measures primarily required in MICs, and focus concessional resources on financing adaptation measures in LICs.

2.2. ODA refocused on the grant element and concentrated on the poorest and underdeveloped countries

ODA, within official development finance, would continue to be subject to specific monitoring practices. Its definition, however, should be refocused on the grant element and its use mainly targeted towards poor countries.

Refocusing the definition of ODA on the grant element

One solution could be to refocus the definition of ODA on its *budget element*. In this case, only budget expenditures (grants, interest rate subsidies, contributions to multilateral agencies) passed by parliament in donor countries to finance development expenditure in developing countries included in a revised version of the DAC list would be recorded as ODA. This would have the advantage of simplicity and clarity for citizens. It would also enable bilateral and multilateral agencies to be treated on an equal footing. Finally, it would eliminate any distortion in resource allocation. The one-off leverage of loans on the volume of ODA would in effect be abolished, as the capital of loans would no longer

be included in ODA, but in the first indicator (ODF). For governments and the democratic debate, it would increase accountability, as results in terms of the volume of ODA would be directly related to the budget decisions of the existing authorities. This contrasts with the present situation, where the volume of ODA in year *n* partially depends on decisions taken many years before, particularly with regard to repayment of loans or debt cancellation. The main disadvantage of this solution is that it only considers the donors' perspective. No attention is paid to the perspective of the recipient country, which is less concerned with knowing the actual budget cost of the expenditure in the donor country than with obtaining concessional resources, or at least at resources at below market cost, i.e. those containing a grant element.

A second option would be to refocus the definition and measuring of ODA not on direct budgetary expenditure alone, but on measuring its *grant element*, including, for example, the opportunity cost of a loan or guarantee. Only the grant element would be included in ODA, with the capital recorded instead under the indicator for 'total official development finance' (described in Section 2.1). However, this option would require a convincing resolution to the debate over the discount rate. The use of a similar or identical rate to those used by the IFIs (5% for IBRD), updated periodically to reflect market changes, seems most appropriate.

Focusing ODA primarily on poor countries, particularly LDCs

This ODA, refocused on its budgetary or grant element, should be concentrated on the poorest and most vulnerable countries, which have no access to capital markets and are not eligible for loans from development banks, or only to a limited extent. Ideally, this would be done by revising the DAC list of developing countries, narrowing it down to countries with a per capita income of between US$7,000 and US$10,000.[6] A second, broader list could include all developing countries eligible for non-concessional finance.

If, for political reasons, a review of the list of developing countries eligible for ODA must be avoided, one alternative would be to set a target for the concentration of concessional aid on poor countries, i.e. a commitment to target 50-70% of ODA to poor countries. This target should be set collectively, by the DAC and, if possible, the United Nations.

6 Currently, this list is chiefly defined by average per capita income (PCI), with countries eligible for ODA as long as PCI does not exceed a ceiling of US$12,800 for three successive years. This limit seems very generous in terms of the allocation of concessional resources, particularly grants. By failing to discriminate between very poor and emerging countries, it penalises the former, which have to share a scarce resource that is their only source of external finance. The limit is also disconnected from the criteria of multilateral development banks, leading to harmful distortions between the various actors of international co-operation. The IBRD, for instance, has set a per capita income limit of US$7,800 for its non-concessional loans. While the IBRD refuses to make this type of loan 'at near-market rates' – despite their representing no budgetary cost – bilateral development banks and agencies are authorised to finance projects in the same country through grants or highly concessional loans.

ODA remains essential for the poorest countries, particularly the Least Developed Countries

In 2011, a third of total aid, but almost 50% of aid allocated geographically, was focused on LDCs.[7] This figure reflects the proportion of LDCs in the global population living below the absolute poverty threshold (30%).

ODA to the LDCs has shown a sharp rise in the past ten years. Whilst total ODA increased by 63% in constant dollars between 2000 and 2010, aid to LDCs more than doubled in the period 2000-11, from US$22 billion to US$46 billion.8 The rise was even more marked in the case of the subset of LDCs on the list of fragile countries (an increase of 169%). However, over the past three years, there has been a decline in programmable aid to LDCs (excluding the impact of debt cancellation) in favour of the MICs.

There has also been an increase in ODA in proportion to GNI. Virtually all DAC donors have progressed towards the target set by the United Nations for aid to LDCs to represent between 0.15% and 0.20% of GNI. Ten DAC countries have now achieved 0.15% (compared with only five for the global target of 0.7%).

ODA plays a key role in financing development in LDCs and MICs

Despite the arguments currently in vogue touting the growing role of other sources of development finance, particularly private investment, LDC figures show that ODA is still the primary fuel for financing development. *In the LDCs, ODA still makes up 70% of net external flows and 40% of revenue on average*.

The situation is different in the MICs, where ODA represents only 6-18% on average of net external flows and 1-5% of revenue, depending on whether the MICs are in the upper or lower bracket. The marginal value of an additional ODA allocation is therefore much higher for LDCs, where it plays a central role in financing basic services, state reconstruction or financing the economy.

This aid dependency is linked to another economic and geopolitical fact, namely the 'fragmentation' of the South, which is becoming increasingly polarised into three categories of country: first, emerging countries in which a growing share of the population, the middle class, are adopting consumption patterns close to those of developed countries; next, the middle-income countries, where per capita income has improved significantly but which face low economic growth and rising inequality; and finally, poor countries, which often belong to the category of LDCs and/or countries in crisis, and lag far behind in terms of the MDGs and the fight against absolute poverty.

Table 2.1 shows the significant divergence in developing countries' economic trajectories, including highly contrasting results in the fight against poverty. While MDG 1, which aimed to halve the world's population living below the absolute poverty line, had been achieved in 2008 (22% against 43% in 1990), this result was mainly due to the success of East Asia, especially China. Results in other developing regions are far less convincing. Sub-Saharan Africa, for example, recorded a slight improvement in percentage terms (48% compared

7 One third of global ODA is not *a priori* allocated geographically (e.g. contributions to global funds or regional and cross-cutting programmes).

8 In constant 2011 dollars.

to 57% at the beginning of the period) but an increase in the number of people living below the absolute poverty line. The same is true with respect to other MDGs. LDCs and other vulnerable countries represent a significant proportion of delays recorded in completing the MDGs. This particular situation justifies a specific effort from the international community, in terms of quality as well as volume. These countries need concessional resources to create the conditions for their release from the 'poverty trap', i.e. the funding basic infrastructure, the accumulation of human capital and the establishment of the rule of law. Such expenditure is rarely taken care of by private investment.

Table 2.1. *Decline in absolute poverty, 1990-2008*

Poverty headcount (per cent living on less than US$1.25 PPP/day)							
	1990	1993	1996	1999	2002	2005	2008
East Asia and Pacific	56	51	36	36	28	17	14
Europe and Central Asia	2	3	4	4	2	1	0
Latin America and the Caribbean	12	11	11	12	12	9	6
Middle East and North Africa	6	5	5	5	4	3	3
South Asia	54	52	49	45	44	39	36
Sub-Saharan Africa	67	59	58	58	56	52	48
Total	43	41	35	34	31	25	22
Millions of poor							
East Asia and Pacific	926.4	870.8	639.7	655.6	523.1	332.1	284.4
Europe and Central Asia	8.9	13.7	18.2	17.8	10.6	6.3	2.2
Latin America and the Caribbean	53.4	52.5	53.6	60.1	62.7	47.6	36.9
Middle East and North Africa	13.0	11.5	12.3	13.6	12.0	10.5	8.6
South Asia	617.3	631.9	630.8	619.5	640.5	598.3	570.9
Sub-Saharan Africa	289.7	330.0	349.2	376.0	390.2	394.9	386.0
Total	1908.5	1910.4	1703.8	1742.6	1639.0	1389.8	1288.7

Source: Calculations based on PovcalNet; World Bank (2012).

These figures shed a harsh light on the differences in developing countries' economic trajectories and the 'fragmentation of the South'. The economic reality of the contemporary world shows that concessional assistance remains a vital component of development finance for poor countries. Moreover, this was its original purpose. The statistics also call for the international community to show more discernment in financing development, through greater discrimination between instruments based on the level of development of each country. A fall in ODA to LDCs could have a disastrous impact on the stability and development

prospects of countries that have little or no access to financial markets and foreign direct investment flows, and which remain prisoners of the 'poverty trap'.

3. Conclusion

3.1. Advocating for the effective and equitable management of development finance

Development cooperation is necessary and will need to grow in the future. In the global village, to paraphrase André Malraux, the twenty-first century will be the century of cooperation or there won't be a twenty-second century at all. The porosity of borders to flows of capital, goods and persons is structural. The growing strength of global risks is a major factor in the potential destabilisation of our classic development models. No country can be exempted from its global responsibilities, though these may differ from one country to another. Emerging countries have understood this, and are greatly increasing their aid budgets. It is no accident that the first country to report to the DAC a volume of ODA that represents 1.25% of its GNI, a historical record, was the United Arab Emirates, nor that the biggest increase among the DAC members in terms of ODA effort was made in 2013 by Turkey. The world is clearly changing.

Development cooperation needs to adapt once again to a new order. It has to incorporate this new geography of poverty and the global risks that threaten the development of all, but especially of the most vulnerable countries. It is highly desirable for the post-2015 agenda to include universal objectives, both for the reduction of absolute poverty and for sustainable development. For the first time, we have the opportunity to eradicate absolute poverty. But we also have to change our growth model to avoid permanently jeopardising the welfare of future generations. Monitoring of development finance must therefore take into account the diversity of both agendas and developing countries' economic trajectories, by establishing effective incentives for the mobilisation of increasing resources and their optimal allocation, according to the characteristics of the countries and programmes to be funded.

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3

China's Contribution to Development Cooperation: Ideas, Opportunities and Financing[1]

Justin Yifu Lin and Yan Wang[2]

'Give a man a fish and you feed him for a day. Teach him how to fish and you feed him for a lifetime.'
Lao-Tze (circa 571-470 BC)

1. Introduction and summary

Today we are facing an increasingly diverse, multipolar and yet interdependent world, one which monolithic explanations of international development seem to fall short in describing. Having lost confidence in the Washington Consensus in the Great Recession since 2008, developing countries are increasingly looking East for development experiences and ideas – what worked, why and how – as well as financing. Similarly, theories describing international aid seem to be inadequate in explaining the diversified financing flows for development goals. A major rethink is in order.

History has shown that structural transformation is critical to economic development; it is the reason that some nations prosper while others languish.[3] Developing countries have for decades been trying to catch up with the industrialised high-income countries, but only a few have succeeded. It took only 35 years for Korea to grow from a war-torn agrarian economy in 1953 to a manufacturing leader in 1988. China started the transformation with pragmatic and geographically differentiated strategies to overcome infrastructure bottlenecks and institutional constraints, achieved an average annual growth rate of 9.8% from 1978 to 2013, and transformed itself from an agrarian economy to a manufacturing powerhouse within a time span of 35 years.

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3 There is an extensive literature on this; see, for example, Akamatsu (1962), Arrow (1962), Gerschenkron (1962), Kuznets (1966), Solow, R.M. (1957), North (1981), Hausmann and Rodrik (2002), Hausmann and Klinger (2006), Lin (2010, 2012a), Rodrik (2010), Greenwald and Stiglitz (2013), Stiglitz and Lin (2013) and UNIDO (2013).

Why was it possible for China to achieve such a dramatic transformation without relying on international aid? What will China's roles be in the post-2015 development cooperation? Based on the theoretical foundation of 'new structural economics' (Lin, 2010, 2011, 2012a), this chapter examines China's role in the post-2015 era from the angle of *structural transformation*. The objective is to examine how China has been utilising what it knows best to contribute to world development: providing new ideas, tacit knowledge, experiences, opportunities as well as finance. We go beyond the discussion of official development aid (ODA) to cover South-South development cooperation with a broader definition, and provide a way of thinking 'out of the box' of 'aid effectiveness'. In addition, we discuss the rationales behind China's proposed grand vision of 'one belt, one road'.

The next section examines the philosophy underlying China's South-South development cooperation (SSDC). The third section discusses some evidence of meeting Africa's infrastructure needs and investing in special economic zones (SEZs). The issues, challenges and prospects for development financing are discussed in the fourth section, and the final section concludes.

2. South-South cooperation for structural transformation: Opportunities and financing

What are the unique features of China's SSDC? First, China's approach to SSDC differs fundamentally from the international aid literature of established donors, focusing on mutual learning, 'poor helps the poor' and 'soldier teaches soldier' by utilising China's comparative advantage and by combining trade, investment and development cooperation. In official language, China follows the principles of equality and mutual respect, reciprocity, mutual benefit, and non-interference in domestic affairs. Aside from adherence to the 'One China' principle, no political strings are attached to China's cooperation (State Council Information Office, 2011). This is not to say that China's aid or development cooperative activities are 'altruistic'; they are not. The government 'never regards such aid as a kind of unilateral alms but as something mutual' (paragraph 1 in the eight principles for economic aid and technical assistance to other countries announced in January 1964). This 'mutual (economic) benefit' is based on the simple idea of 'exchanging what I have with what you have' (*hutong youwu*), from which both can gain, as we learned from Adam Smith. This is actually a market-based approach that ensures the incentives of both partners are aligned.

Second, the State Council's 2006 White Paper on "China's Africa Policy" listed 'learning from each other and seeking common development' as one of the four principles guiding its engagement with the continent. This is a unique principle that no Western donor has specified in its documents. Since learning is an action initiated by the learners themselves (certainly not imposed by teachers), we found this is a feature very closely related to 'putting the African countries in the driving seat' and hence developed our joint learning and co-transformation model (Lin and Wang, 2014).

Third, the scale of China's aid and South-South cooperation is small but commensurate with its per capita income level. Many analysts have compared the amount of ODA from China and established donors such as the United States without considering the huge differences in income per capita, which is rather misleading.[4] When China started to provide development assistance to African countries 50 years ago, it was poorer than most of the sub-Saharan African countries. Even now, China's per capita income, at around US$7,000 in 2014, is only an eighth or a tenth of that of the established OECD donor countries (see Box 1 in Lin and Wang, 2014).

China's definition of aid differs from that of the OECD's Development Assistance Committee,[5] and therefore direct comparison does not make sense. According to the State Council's White Paper on "China's Foreign Aid", China provides grants, interest-free loans and concessional loans, with eight forms of foreign aid: 'complete (turn-key) projects, goods and materials, technical cooperation, human resource development cooperation, medical teams sent abroad, emergency humanitarian aid, volunteer programmes in foreign countries and debt relief' (State Council, 2011, p. 8).[6]

Due to demand from African countries, new types of SSDC have been added in recent years, including other official flows (large but less concessional loans and export credit provided by the Eximbank of China), resource-financed infrastructure (RFI) packages,[7] equity investment by the China-Africa Development Fund (CAD Fund), and infrastructure investment by the China Development Bank (CDB) and other commercial banks (which are OOF-like loans and investments intended for development, but are non-concessional and suitable for long-term infrastructure investment).

3. South-South development cooperation is effective

Based on our model of 'joint learning and co-transformation', our first proposition is as follows.

Proposition One: A partner who is successful in transformation can utilise its comparative advantage in development cooperation to help diffuse 'tacit' knowledge on the 'how to' issues of development.

This also provides a basis for multiple partners working together in one 'host country' for structural transformation, job creation and welfare improvement – each partner can work in sectors where they have respective comparative

4 Studies include Wolf *et al.* (2013) from Rand, and Strange *et al.* (2013) from the Center for Global Development.

5 According to the OECD definition, official development assistance (ODA) includes grants or loans which are a) undertaken by the official sector; b) with promotion of economic development and welfare as the main objective; and c) *'concessional in character* and convey a grant element of at least 25 per cent (calculated at a rate of discount of 10 per cent)' (see http://www.oecd.org/dac/stats/officialdevelopmentassistancedefinitionandcoverage.htm).

6 See Bräutigam (2011) and Xu and Carey (2014) for detailed discussions of these.

7 See World Bank (2014), with comments from Lin and Wang.

advantages. The United States, for example, has comparative advantages in health care, education, food production and information technology, among others. China has revealed comparative advantages (RCAs) in 45 out of a total of 99 subsectors in merchandise export (HS 2-digit code), as well as demonstrated capacity in the infrastructure construction sector, including building hydropower stations, roads, railways and port facilities. It is therefore in a better position to transmit 'tacit knowledge' in these sectors. In infrastructure, China is able to provide a 'total solution' – including design, engineering, financing and construction implementation – that other donor countries may not be able, or willing, to provide.

Proposition Two: Learning can happen by taking tiny steps, 'one step at a time', which are commensurate with a country's natural endowments or accumulated factor endowments.

Since China has conducted *partial reforms* using an experimental approach, it can help others implementing the same partial reforms through SEZs and experimentation. China's development cooperation follows the logic of New Structural Economics by helping Africans to *take tiny steps* in agriculture, infrastructure and labour-intensive light manufacturing sectors. It is well known that China did not eliminate all trade barriers in the 1980s, but established four SEZs that facilitated learning and experiments (Lin, 2012b). Partial reforms through SEZs have also helped in structural transformation in China: by 2007, major national-level SEZs accounted for 21.8% of national GDP and 30% of merchandise exports, and attracted 46% of FDI inflows (Zeng, 2010, p.14). Partner countries need to have recent intimate 'tacit' knowledge and experiences in order to be able to help in such an experimental approach. In what follows, we present two forms of evidence to support these propositions.

3.1. China's development cooperation helps to address Africa's bottlenecks

Non-traditional bilateral development financiers, such as China, India, the Arab countries and Brazil, have emerged as major financiers of infrastructure projects in Africa. Overall, infrastructure resources committed to Africa by these countries jumped from US$1 billion per year in the early 2000s to over $10 billion in 2010. In 2010, China held a portfolio of some $20 billion in active infrastructure projects in more than 40 African countries. Chinese financing for African infrastructure projects is estimated to have reached a record annual flow level of roughly US$5.1 billion in 2009, though it fell to around $2.3 billion in 2010 (Chen, 2013).

In particular, China has been working in bottleneck-releasing sectors such as power generation and transmission. While '[d]onors have neglected power since the 1990s', (Foster and Briceño-Garmendia, 2010, p. 25), 50% of China's commitment to infrastructure was allocated to electricity (Chen, 2013). A recent study found that China has contributed or is currently contributing to a total of *9.024 gigawatts* of electricity generating capacity, including completed, ongoing

and committed power projects.[8] The impact of this investment is likely to be transformative when one considers that the entire installed capacity of the 47 sub-Saharan African countries, excluding South Africa, is 28 gigawatts.

In Box 3.1 we provide empirical evidence that, to a significant extent, Chinese-financed infrastructure projects in 2001-2010 targeted and addressed bottlenecks in African countries in five sectors: water, electricity, road and rail, air transport, and telecommunications (based on PPIAF China project data). The total number of projects in the dataset is 168 across the five sectors, and the probability of these China-funded projects 'hitting one of the bottlenecks' in the period 2001-2010 is 62.5%. There is, however, much room for improvement and better targeting, especially in the water sector.

From January 2010 to May 2012, China approved concessional loans worth a total of US$11.3 billion for 92 African projects. The Addis Ababa-Adama Expressway in Ethiopia and the Kribi deep-water port in Cameroon, for example, were both funded by concessional loans from China. Some of China's main commercial banks have also started the buyers' credit businesses in Africa, supporting the power grid in Ghana, hydropower stations in Ethiopia and a west-east expressway in Algeria, among other projects (MOFCOM, 2013).

Box 3.1. *China helps to address the infrastructure bottlenecks in Africa*

In a recent study that ranks the donors/providers of infrastructure in sub-Saharan Africa for the period 2001-2008, China is shown to be the largest infrastructure financier followed by three multilateral organisations: IDA, EC and AFDF. In total, there are three Southern providers in the top ten: China, India and ISDB. *China alone accounts for 34% of the total official financing of infrastructure in SSA*, higher than any Northern partner (Chen, 2013).

In Lin and Wang (2014), we use a three-step method to address the question of whether, and to what extent, Chinese-financed infrastructural projects match African bottlenecks. The short answer is that they seem to have matched in 62.5 per cent of the 168 infrastructure projects from 2000 to 2010. *In step one*, five indicators from the World Bank database are used to define bottlenecks in African countries, which include water, electricity, roads and rail, air transportation and telecommunication. We first compare the rankings for sectors 1 to 5 for country i, and select the lowest ranking sector as bottleneck 1 for country i. Then we exclude the selected sector j^*, and select the next lowest ranking sector from the remaining sectors as bottleneck 2, and follow this process again for bottleneck 3.

This process can be expressed as,

$$\textit{Bottleneck } 1 \textit{ for country } i = \min(R_{i,j}), \textit{ where } j = 1, \ldots 5$$
$$\textit{Bottleneck } 2 \textit{ for country } i = \min(R_{i,-j*}), \textit{ where } j = 1, \ldots 5$$

8 The Hoover Dam in Colorado, by comparison, is a two-gigawatt facility, producing on average electricity for about 390,000 US homes (Chen, 2013).

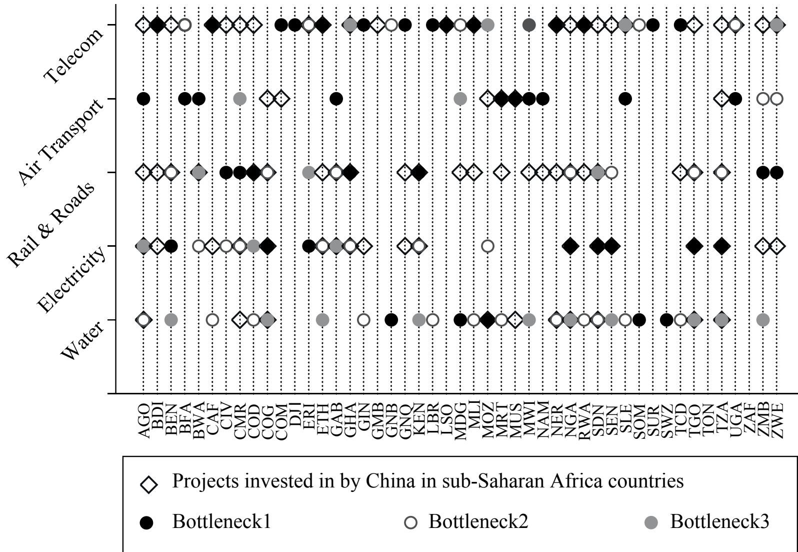
Box 3.1. *(contd.)*

In step two, the World Bank-PPIAF Chinese projects database is used to find the location and number of infrastructure projects financed by China in each sector during the period 2001–10. There are 168 projects allocated in 5 sectors.

In step three, the two datasets are merged by country code to see if the locations of the Chinese financed projects match the bottlenecks. We have also calculated some probabilities of projects 'hitting' the bottlenecks. The results are as follows:

- Probability of hitting one of the 3 bottlenecks = 105/168 = 0.625 = 62.5%
- Probability of hitting bottleneck 1 = 39/168 = 0.232
- Probability of hitting bottleneck 2 = 31/168 = 0.185
- Probability of hitting bottleneck 3 = 35/168 = 0.20

Figure 3.1. *Chinese-financed projects helped to address bottlenecks in sub-Saharan Africa in 62.5% of the cases, 2001-2010*



Source: Lin and Wang (2014), Annex I.

3.2. China has been helping to develop cluster-based industrial parks

The idea that industrial clusters can promote structural transformation is not new; economists have long emphasised that clusters take advantage of economies of scale to reduce transaction, search and learning costs (Krugman, 1991; Lin and Monga, 2011; Greenwald and Stiglitz, 2013). The role of SEZs or industrial parks has been demonstrated by the successful experiences of emerging markets. Specifically, investing in SEZs can (i) allow bundling of public services in a geographically concentrated area; (ii) improve the efficiency of limited government funding/budgets for infrastructure, (iii) facilitate cluster development, or agglomeration of certain industries; and (iv) promote urban development and conglomeration of services. They are thus conducive to growth, job creation and income generation (Lin and Wang, 2013, p. 14)

China has supported 19 SEZs around the world – six of which are in Africa – aimed at improving regional infrastructure and encouraging outward investment into these low-income developing countries where needed. According to detailed studies by Bräutigam and Tang (2014), China has jointly established a total of six industrial zones in Africa. Over 80 companies have signed agreements and settled in these zones, creating over 11,000 jobs for African workers. For example, the well-reported Huajian Shoe Company, located in the Eastern Industrial Park of Ethiopia, has created over 3,500 local jobs since it started operations in 2012[9] (see also World Bank, 2011, 2012; Shen 2013).

China's labour cost has risen rapidly from US$150 per month in 2005 to US$500 in 2012, and to over US$600 in coastal regions in 2013 (growing at a rate of 15% annually plus currency appreciation of nearly 3%). More and more Chinese enterprises facing the pressure of finding low-cost locations are either moving inland or 'going global'. China has an estimated 85 million workers in manufacturing, most of these in labour-intensive sectors, compared with 9.7 million in Japan in 1960 and 2.3 million in Korea in 1980. The reallocation of China's manufacturing to more sophisticated, higher value-added products and tasks will open up great opportunities for labour-abundant, lower-income countries to produce the labour-intensive light manufacturing goods that China leaves behind (Lin, 2012c; Chandra *et al*., 2013).

China is taking the lead amongst the BRICS countries in outward FDI, its contribution rising from a few million to over US$101 billion in 2013, with Russia, Korea, India and Brazil following (UNCTAD data, accessed in October 2014). Roughly 60% of outward FDI from developing countries went into other developing countries, mostly in the form of greenfield investments that can typically open the door for South-South relocation of various industries from China and other emerging economies. While there is widespread suspicion of China's motivations and criticism of its record of following international standards, some studies have shown that the investment has generated employment

9 See http://www.bloomberg.com/news/2014-07-22/ethiopia-becomes-china-s-china-in-search-for-cheap-labor.html.

opportunities.[10] Manufacturing is China's key area of investment in Africa. From 2009 to 2012, Chinese enterprises' direct investment volume in Africa's manufacturing sector totalled US$1.33 billion. By the end of 2012, China's investment in Africa's manufacturing industry had reached US$3.43 billion (MOFCOM, 2013). Official data, however, is incomplete and underestimated China's outward FDI by the order of three to one according to Shen (2013).

4. Future prospects of development finance

4.1. Future prospects of development financing

As some established donors are constrained by their heavy debt burden and slow growth, development financing will come less from ODA and increasingly from other official flows (OOFs), OOF-like loans, and OOF-like investments from development banks in emerging economies. Therefore, China's South-South development cooperation is likely to expand. For instance, Chinese President Xi Jinping and Premier Li Keqiang have made fresh commitments to invest in Africa and Latin America (Li, 2014). These loans are more likely to be OOF-like loans or OOF-like investments due to the nature of large infrastructure projects.

China's official stance in its White Papers (State Council, 2014) has reflected a renewed confidence in the country's own approach to development cooperation, which stresses 'blood creation' rather than 'blood transfusion' (Freeman, 2012), as well as greater doubt about Western donors' approach of providing 'aid with conditionality'. In particular, 'aid for infrastructure construction' is clearly identified as one of the most significant channels for Chinese aid. As a comparison, while China reported to have helped build 390 'economic infrastructure' projects (road, rail, telecom and power generation) between 1950 and 2009, the number was 156 projects in just the three years from 2010 to 2012. In addition, the share of assistance to Africa increased from 45.7% in 2009 to 51.8% of the total in 2012 (State Council, 2014). Meanwhile, the credibility and relevance of ODA for global development have been questioned by OECD members themselves (Hynes and Scott, 2013; Boussichas and Guillaumont, 2014; OECD-DAC, 2014a).

We propose to start a discussion on broadening the definitions of 'development financing'. The OECD-DAC definitions of ODA and OOFs are a good starting point, but they need to be reformed for clarity and to take into account all forms of finances aimed at supporting development. With regards to monetary policy instruments, there are M0, M1, M2, and M3. In development finance, we can define DF1, DF2, DF3 and DF4 similarly, according to (a) the extent of 'concessionality' with a consistent benchmark market interest rate, (b) the source (the extent of 'official' or state involvement), (c) the destination countries (low- or middle-income developing countries), and (d) the objectives of the financing

10 A few studies have found that China's outward FDI has contributed to employment generation in both developing and industrial nations; see, for example, Shen (2013), Weisbrod and Whalley (2011), Mlachila and Takebe (2011), Rosen and Hanemann (2011) and Scissors (2012), and World Bank (2012) on China's FDI in Ethiopia.

(economic development or welfare).[11] A new set of clearer definitions would facilitate transparency, accountability and selectivity by development partners, encourage sovereign wealth funds (SWFs) to invest in developing countries, and facilitate public-private partnerships (PPPs) in developing country infrastructure. In particular, sovereign wealth funds across the world are currently managing huge amount of assets – in excess of $7 trillion US dollars[12] – and many of these are seeking higher risk-adjusted returns.

Concretely, we propose to redefine development finance (DF) in the following ways:

- DF1 = ODA as defined by OECD-DAC (2014b) with proposed improvements in the calculation of concessionality.
- DF2 = DF1 + OOFs, including preferential export credit.
- DF3 = DF2 + OOF-like loans (loans from state entities for development, but at market interest rates.
- DF4 = DF3 + OOF-like investment (equity investment by SWFs or development projects supported by state guarantees, or public-private partnership (PPP) projects for public infrastructure, which provide global public goods for sustainable development). This latter concept will be consistent with the Total Official Sustainable Development (TOSD) proposed by OECD-DAC in December 2014 (OECD, 2014b).

Special attention should be paid to the non-monetary development assistance provided by Southern partners, such as turnkey projects, real sector (barter) exchanges and RFI. In our view, the RFI concept can help connect resource extraction with the construction of 'bottleneck releasing' infrastructure – two otherwise separate supply chains – thereby reducing transaction costs and making public infrastructure more attractive to the private sector. 'An RFI credit may be the least-cost option for obtaining essential infrastructure that cannot generate sufficient revenue to support a project finance transaction' (comment by Lin and Wang in World Bank, 2014, p. 76).

Other categories may include pure private contributions to development without state involvement. As some element of South-South development cooperation cannot be monetised, such as numbers of volunteers and medical doctors, separate categories can be established for those. Figure 3.2 roughly summarises our ideas.

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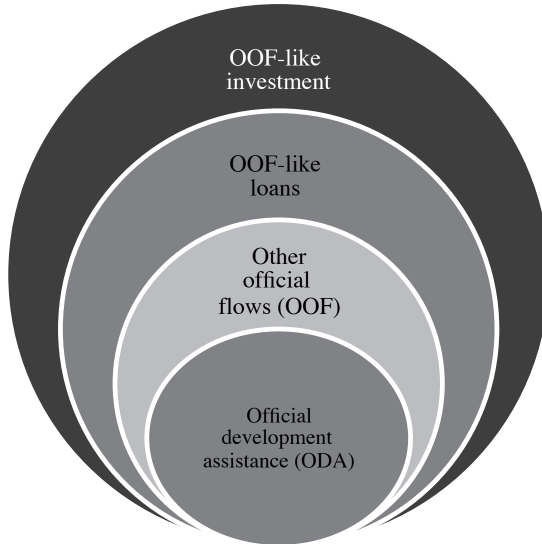
11 This idea has also been alluded to in several previous studies, including Bräutigam (2011), Strange *et al*. (2013) and OECD-DAC (2014a).

12 SWF Institute (at http://www.swfinstitute.org/fund-rankings/).

Figure 3.2. *Proposal for an expansion of the definition of development financing*



Notes: The circles correspond to DF1 = ODA; DF2 = ODA + OOF; DF3 = DF2 + OOF-like loans; and DF4 = DF3 + OOF-like investments. Another category may be added separately for SSDC that cannot be monetised.

4.2 Global governance matters

The availability of international development finance, however, also depends on institutional arrangements, the channels of financing and, ultimately, the structure of global governance. In other words, it depends on whether the SSDC or DF is welcomed, whether and how much the voice of emerging market partners are being included, and whether they are invited to the table to shape the global 'rules of the road'.

The availability of China's future development finance depends on many factors, so a linear extrapolation is not appropriate. A better method is to take China's projected growth rate in the next ten years and to use the ratio of the country's development finance to its gross national income (GNI), currently at 0.15% of GNI, as a guide for making projections. The following source may provide a clue to the availability of Chinese-sourced development financing (under a broad definition). According to one of the studies by staff of the People's Bank of China, the estimated outward investment in infrastructure 'will not be less than US$100 billion annually (that is RMB630 billion yuan)' (Jin, 2012). 'Considering the increased potentials, China could well afford to have outward investment of RMB600 billion to RMB1,000 billion yuan per year. Assume that this amount consists of 95% in loans and equity investment, and 5% in grant, this means that China's Ministry of Finance will need to budget RMB30 billion to 50 billion yuan for international aid. This number is only about 0.3% to 0.5% of

China's 2011 fiscal revenue, accounting for less than 0.1% of GDP, much lower than the fiscal burden of the Marshall Plan (to the US Treasury)' (Jin, 2012, p. 62)

In our view, as China's GNI and fiscal revenue continue to grow, the amount of development finance will continue to grow. However, this depends on the global governance system. Two possible trends are emerging:

1. *Multilateralism*. China and Southern partners may move towards more multilateral and trilateral collaboration with the World Bank and other established regional development banks. This would provide more learning opportunities for emerging partners, enhance triangular knowledge exchange and, hopefully, improve the effectiveness of both the established and emerging donors. For example, China Eximbank and CDB have both signed MOUs with the World Bank (in September 2013) to conduct trilateral collaboration.

2. *New groupings with plurilateral features*. In response to the gridlock in reforming the global governance structure, in particular in reforming the IMF's voting shares, new groupings have emerged and will continue to emerge outside the 'established' international development finance organisations. For example, the BRICS countries have made concrete progress and funding commitments to establish a New Development Bank (formerly the BRICS Bank) with a $50 billion initial capital commitment, and a contingency reserve arrangement (CRA) with an initial commitment of $100 billion (Fortaleza Declaration by the BRICS leaders, July 2014).[13] In addition, Chinese leader Xi Jinping announced a new vision to build 'a Silk Road Economic Belt and the Twenty-First Century Maritime Silk Road' ('one belt, one road'), which are supported by over 50 countries. As the concrete financing mechanisms, the Asian Infrastructure Investment Bank (AIIB) and a Silk Road Fund will be established. Twenty-seven (27) countries have signed the agreement to be the founding members of the AIIB, with New Zealand joining on 4 January 2015. The United Kingdom, France, Germany and Italy have recently submitted applications to join the Asian Infrastructure Investment Bank (AIIB) as founding members, taking the number of funding member countries to 52 by 31 March 2015. This leaves only Japan and the United States in the G7 who have been left out. There is also an additional proposal to establish a Global Structural Transformation Fund (GSTFund), which will help fund the transformation process in Africa (Lin and Wang, 2013).

13 http://brics6.itamaraty.gov.br/media2/press-releases/214-sixth-brics-summit-fortaleza-declaration.

What are the rationales behind the grand vision of 'one belt, one road'?
In our view, the 'one belt, one road' vision reflects China's ideas and experiences of development – structural transformation and 'building infrastructure as a countercyclical measure to global recession'. China has used expansionary monetary and fiscal and investment policy to overcome the contractory pressure during two crises – the 1998 Asian financial crisis and the 2008-2009 global financial crisis – and in the aftermath of the Great Recession. Now, after seven years of resistance, the idea of building infrastructure as a countercyclical measure in a low-interest environment is well accepted (IMF, 2014; Summers, 2014).

The 'one belt, one road' vision also reflects the demand from relevant countries for releasing infrastructure bottlenecks and improving connectivity with large markets in China and Europe, as well as the need arising from China's own development. As explained earlier, China and other developing countries are teammates climbing the same mountain of structural transformation – one country cannot climb to the top without others doing equally well. While other developing countries are constrained by inadequate capacity, tacit knowledge and financing resources, China is facing severe constraints on energy, land, labour and the environment. Working together, they can complement each other and achieve win-win solutions.

Finally, the 'one belt, one road' vision reflects Chinese leaders' vision for 'peaceful co-existence with differences' and their commitment to providing global public goods and promoting sustainability. Deeply rooted in China's thousand-year history and civilisation is the firm believe among Chinese people that 'one should not impose on others what he himself does not desire'. The principle, which has been consistently implemented by China in the last 50 years, will be further modernised and strengthened by the current generation of leaders. The implication is that 'the Pacific Ocean is large enough' to allow the emergence of many developing nations peacefully, and that the rise of China is conducive to world peace and shared prosperity.

4.3. Issues and challenges for China's SSDC

The first challenge for China's South-South development cooperation is the lack of transparency in the SSDC projects – official data at the project level is not readily available. The publication of the White Paper on "China's Foreign Aid" (State Council, 2011; 2014) and of "China Africa Economic and Trade Cooperation 2013" (MOFCOM, 2013) and China's African Policy (MOFA, 2006) were steps in the right direction. The government needs to be more open and pro-active in providing more accurate data and in making laws and regulations clear on development cooperation. This would be favourable to increased accountability to taxpayers in China, as well as to the international development community. China does not have a legal framework governing foreign aid, nor does it have an independent aid agency. So it is difficult for Chinese citizens to participate in the decision-making process on foreign aid, for Chinese officials to be held accountable, and for international bodies and governments to seek collaboration

on international development or financing issues. In our view, drafting China's law on foreign aid and cooperation and establishing an independent aid agency should be priorities on the policy agenda.

The second concern is over 'tied aid' and inadequate technological diffusion and spillover effects. Most Chinese aid is tied, a practice that members of OECD-DAC have agreed to move away from progressively since 1995, since tied aid can increase costs and reduce efficiency. However, China's experience indicates that 'tied aid' had some advantages in terms of facilitating 'learning by doing' and learning by implementing projects, as can be seen from the learning model discussed in Lin and Wang (2014). According to Hausmann (2013), 'the tricks of the trade are acquired from experienced senior workers'. The academic literature on aid and trade found mixed results (Morrisey and White, 1996; Lloyd *et al.*, 2000; Wagner, 2003). The value of actually implementing projects in learning and development seems to be under-appreciated by economists and the donor community. In the 1980s and 1990s, most donor-financed projects located in China were 'tied aid', and Chinese workers and project managers have learnt and benefited from them (Wang, 2011). In fact, 'learning from aid projects' is one of the reasons why Chinese companies are so competitive in implementing construction projects.[14]

The third concern is that Chinese aid projects seem to have generated few local employment opportunities. Many African officials are concerned that Chinese workers are displacing local workers. Although the data and evidence need to be discussed on a case-by-case basis, clearly the indirect employment generation from Chinese-financed economic infrastructure has been under-researched. The IMF finds that '[i]n recent years, China has become the largest single trading partner for Africa and a key investor and provider of aid,' and that 'a one percentage point increase in China's real domestic fixed asset investment growth has tended to increase sub-Saharan Africa's export growth rate on average by 0.6 percentage points' (IMF, 2013, p. 5). Better education and training should be provided to enable Chinese companies to abide by laws and regulations regard labour, social and environmental standards. In addition, better training and capacity development programmes should be provided to African workers and managers in order to help fulfil the requirement of timely completion of projects showing tangible results.

No two countries are the same in their economic transformation. China has made some mistakes and paid a 'high tuition' in the learning process; for instance, the country's strong drive for rapid growth and industrialisation is associated with widening rural-urban income disparities and a degradation of environment. In March 2007, the former Chinese Premier Wen Jiabao pointed out that *China's growth was 'unbalanced, inequitable and unsustainable'*. Since then, there have been tremendous efforts to 'rebalance' the economy – reducing its reliance on exports, investment and paying more attention to the quality and efficiency of growth. However, making deep transformations and upgrading industries have proven extremely difficult, as reforms often go against the powerful vested

14 See also Bahar *et al.* (2014)

interest groups. In this sense, African countries need to be selective to avoid the mistakes China has made. African governments, NGOs and CSOs can play important roles in providing pressure to ‘push’ development partners including China and Chinese companies in the right directions.

5. Conclusion

Development financing is not a zero-sum game. Addressing the bottlenecks in low-income countries could yield good returns for all stakeholders, as well as achieving developmental results on the ground. We believe that the post-2015 era will witness a significant structural transformation in most low-income countries.

To be effective, aid or development cooperation must be in the host country’s own interest and be demand-driven. Combining trade, aid and investment – a market-based approach – can ensure the alignment of incentives among equal partners, as shown by the successful experiences in many East Asian countries.

China needs to continue to learn in order to become a better development partner, by listening to the voices from partners and by interacting with governments, NGOs and CSOs. China also needs to be more open and transparent in providing accurate data on international development financing and activities. It is our view that any deals made in the dark are more likely to be revoked or renegotiated by the next government of the client country.[15] Political economy dynamics must be taken into consideration when in discussions with the current government of the client country.

The established donors among OECD countries also need to see whether China’s approach can provide useful lessons to improve the effectiveness of conventional North-South aid. A recent study by the World Bank (2014) also reviewed the RFI approach and found it to be more effective in advancing the developmental impact ‘many years ahead of’ the conventional North-South approaches. According to the study, many African leaders find China’s RFI approach desirable as it has led to ‘inexpensive and tangible results’ within the time span of three to four years, coinciding with the political cycle in a democracy.

In the post-2015 era, development financing will come less from ODA and increasingly from other official flows (OOF), OOF-like loans and OOF-like investment from new and old development banks, SWFs and from emerging economies. Therefore, we propose expanding the definitions of development finance, which could induce more contributions from SWFs and other public or private entities.

In a multipolar world, the prospect of South-South development cooperation is likely to expand, as shown by the ‘one belt, one road’ vision and the establishment of the New Development Bank, the AIIB and the Silk Road Fund. However, established donors/ partners need to be more inclusive to enhance the voice of emerging partners and to provide a place for them ‘at the table’. In the

15 See Lin and Wang’s comment in World Bank (2014), page 77.

post-2015 era, the emergence of new multilateral or plurilateral development banks and funds is encouraging, bringing positive energy and momentum to the world economic development arena. In a multipolar world, new plurilateral and multilateral development banks and funds seem inevitable. Based on evidence presented above, we are cautiously optimistic that common ground can be found for partners from the North and the South to work together on 'win-win' solutions for sustainable development and world peace.

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4

Role of South-South Cooperation in the Context of the Post-2015 Agenda

Debapriya Bhattacharya

1. The context

The legacy of South-South cooperation (SSC) dates back more than six decades, in particular to the 1955 Bandung Conference of the Afro-Asian developing countries. The establishment of the Non-Aligned Movement (NAM) in 1961 and the Group of 77 (G77) in 1964 gave institutional embodiment to the concept of SSC. A number of events and initiatives between the creation of the United Nations Conference on Trade and Development (UNCTAD) in 1964 and the hosting of the High-Level United Nations Conference on South-South Cooperation in Nairobi in 2009 sequentially promoted the process of SSC. One of the high points of this process was the declaration of the 19th of December as the annual UN Day for South-South Cooperation in 2003.

The content of the SSC process was provided, *inter alia,* by the demand for a new international economic order, efforts to operationalise technical and economic cooperation among the developing countries, the adoption of global targets to provide international development assistance, and provisioning capacity-building support to the developing countries in the areas of trade and investment, health and education, and regulatory and institutional reforms. The realisation of all of these aspirations implied that SSC needed to be mainstreamed in the national development framework of the developing countries – both as ‘providers’ and as a ‘recipients’ of cooperation inputs. Thus, SSC had been an evolving process and the recent developments in this regard have to be situated in a continuum.

Developing countries, in particular the low-income ones, are currently exploring the potential role that SSC could play in promoting the structural transformation of their economies. This quest has been fuelled by the dynamism demonstrated by the emerging economies, against the backdrop of multiple crises experienced by the developed world in the recent past. The fluctuating flows of foreign assistance from the developed countries following the recent global economic and financial crisis also prompted the low-income countries to take further interest in SSC. The promise of reforms unleashed by the adoption of the Paris Declaration on Aid Effectiveness and the emphasis on the new-found concept of the ‘development effectiveness of aid’ have provided a set of reference points for taking a fresh look at the modalities and outcomes of

SSC. Currently, SSC is also gaining prominence since it is considered one of the potential instruments for the implementation of the post-2015 development agenda. The recent collective decision by Brazil, Russia, India, China and South Africa (the 'BRICS') to set up a 'new development bank' and a reserve fund has added new momentum to the SSC dynamics.

As the Southern economies emerged as important players in the international economic landscape and acquired some institutional maturity, the scope and modalities of SSC also underwent discernible changes. The latter resulted, among others, in greater economic exchanges among the Global South. A substantive presence in the global arena and enhanced South-South economic transactions have placed greater demand on the emerging economies of the South to play an expanded role in international development cooperation. The Southern leaders have always maintained that SSC does not carry the baggage of 'colonial guilt', but is based on solidarity and shared development aspirations of the developing countries. Concurrently, SSC has been mentioned in a number of recent outcome documents of high-level international conferences on financing for development (FfD) (GPEDC, 2014). It has been also mentioned in the Zero Draft of the Third International Conference on FfD that is to take place in July 2015 in Addis Ababa (United Nations, 2015a).

As the global development community engages in shaping the Sustainable Development Goals (SDGs) as the successor to the Millennium Development Goals (MDGs), attention has been refocused on SSC as a means of implementation (MoI) for the new international development agenda. The goals and targets of the SDGs are to be approved at a UN Summit in September 2015. This is being done while recognising the fact that resources and expertise received from the leading Southern countries are no substitute for, but are rather complements to, concessional aid flows, export market preferences and other preferential measures committed by the developed countries. Yet, how adequately SSC fits into the emerging framework of global development cooperation needs to be understood better and clarified further.

1.1. Aims and structure of this chapter

The basic objective of this chapter, in the above-mentioned context, is to improve our understanding regarding the dimensions of SSC and the challenges it faces in terms of contributing to the delivery of the post-2015 agenda. Specifically, the chapter, after revisiting the definition of SSC, tries to trace the economic presence of the Global South in the world economy, to explore the current role of SSC envisaged in different outcome documents on FfD, and to highlight the opportunities and challenges for SSC as it positions itself in servicing the SDGs.

The present chapter has followed a historic analytical framework where it has discussed relevant economic trends (from 2000 onwards) and scrutinised outcome documents of various conferences (and high-level meetings) on FfD. The 'Global South' in this chapter essentially refers to countries other than the OECD countries, which currently number 34 (as per the OECD database). In

other words, the Global South essentially comprises of the high-, middle- and low-income countries (following the World Bank categorisation).[1]

While it is relatively easy to take an empirical approach to defining the Global South, it is not so easy to define what constitutes SSC, as this may vary depending on the objectives of the partnership as well as its operational modalities. SSC is often described by the features that distinguish it from traditional North-South cooperation.

For the present study, we have used an instrumentalist definition of SSC guided by its operational manifestation as identified by the United Nations. According to the United Nations (2012), 'South-South Cooperation is a process whereby two or more developing countries pursue their individual and/or shared national capacity development objectives through exchanges of knowledge, skills, resources and technical know-how, and through regional and interregional collective actions, including partnerships involving governments, regional organizations, civil society, academia and the private sector, for their individual and/or mutual benefit within and across regions'.

The structure of the chapter follows its objectives. Following this introductory section, Section 2 focuses on the economic growth of the Global South and also looks at the growing intra-South economic transactions. How different international processes on development finance have treated the issues of SSC is reviewed in Section 3. Finally, Section 4 seeks to identify some of the conceptual and operational opportunities and challenges confronting SSC with regard to its role in the context of the upcoming post-2015 agenda.

2. The presence of the South in the global economy

The Global South (as defined above) has, over the last few decades, acquired enough economic muscle to make its presence felt in the global arena in a substantive way. In 2013, the Global South accounted for 37% of global gross domestic product (GDP), while the comparable figure for 2000 was less than 22%. In terms of global industrial output, the share of the Southern countries increased from a little above 27% to about 48% between 2000 and 2012.

This presence of the Global South in the world economy manifests itself most explicitly in international financial and trade (goods and services) flows. These flows include official development assistance (ODA) and other official flows (OOF), foreign direct investment (FDI), remittances (received and paid) and exports and imports of goods and services. Table 4.1 reports on the secularly growing share of the South in the global economy during the last decade (2000-2013).

1 World Bank (2015).

Table 4.1. *Share of the Global South in the global economy (as a percentage of the global total)*

Items		Years			
		2000	2005	2010	2013
Net ODA and OOF	Share received	94.4	99.3	98.7	97.3*
	Share in Southern GDP	0.9	1.1	0.6	0.5*
FDI	Inflows	17.1	33.6	47.1	55.7
	Outflows	11.3	16.0	29.0	35.3
Remittances	Received	50.7	62.0	69.5	67.6
	Paid	25.1	28.8	35.5	42.6
Trade in goods and services	Exports	28.1	33.3	39.5	41.8
	Imports	25.4	29.1	36.7	39.7

Note: *Data from 2012.

Source: FDI: Calculated from the UNCTAD database (http://unctad.org/en/Pages/Statistics.aspx); ODA, Remittance, and Trade: WDI database.

It may be observed from Table 4.1 that an overwhelming share of net ODA receipts is attributable to Southern countries. However, we note that this share experienced a decline, falling from its peak of more than 99% of global ODA and OOF flows in 2005 to 97.3% in 2012. However, the ODA/OOF flow figures need to be considered in conjunction with the data on the falling aid dependence of the Southern countries. Between 2000 and 2005, the average share of ODA in the GDP of the Southern countries was about 1%, but this had been halved by 2012. Changes can also be seen in the shares of ODA and OOF received across the different categories of Southern countries. For example, the share of low-income countries (as a percentage of global flows) increased from 17.7% in 2000 to 29.6% in 2012, while for middle-income countries it fell from 50.1% in 2000 to 41.8% in 2012. It may be noted that several emerging Southern donors have been providing notable amounts of ODA and OOF in recent years. The contribution of emerging Southern donors[2] (as a percentage of the global share) increased from 2.2% in 2005 to 10.7% in 2013.

However, the economic might of the South is best illustrated by its growing shares of global FDI, remittances and trade (in goods) flows. In the case of FDI, Southern recipients trebled their share from about 17% of the global total in 2000 to more than 55% by 2013. Similar growth may be observed in case of outflows of FDI, where the South's global share of the global total increased from 11.3% in 2000 to 35.3% in 2013.

In the case of remittances, Southern countries strengthened their positions between 2000 and 2013 – both as providers and recipients of remittances by expatriate workers. Starting from a benchmark of more than 50% of total global recipients of remittances in 2000, Southern countries accounted for 67.6% by 2013. In a similar vein, Southern countries have increasingly emerged as a

2 Brazil, China, Chinese Taipei, India, Russia, South Africa, Thailand, Kuwait, Saudi Arabia and the United Arab Emirates (UAE).

dominant source of remittances, with their share of the global total of remittance payments increasing from 25% in 2000 to 42.6% in 2013.

The share of global trade attributable to Southern countries has also experienced a robust upward trend. Exports originating from the South accounted for around 28% of the global total in 2000, while the comparable figure for 2013 was close to 42%. This export expansion took place in parallel with a growth in imports by the South. While in 2000 the Southern share of global imports was 25.4%, by 2013 the corresponding figure was 39.7%.

In recent times, various innovative sources have found a place in the composition of development finance in Southern countries. Such forms of innovative development include sovereign wealth funds (SWFs), diaspora bonds and climate change funds. A number of SWFs emerged in Asia, especially in West Asia, as a result of the energy price escalation during 1970s and 1980s. Asia as a whole constituted 77% of global SWFs in 2011 (Sobhan, 2014). In recent times, the investments of these funds have been diverted to dynamic countries of East/South-East Asia, and even South Asia.

A diaspora bond can be defined as a debt instrument issued by a country, a sub-sovereign entity or a private corporation in order to raise finance from its diaspora. A number of countries in the South have introduced diaspora-targeted financial instruments, including Bangladesh, China, India, Indonesia, Pakistan, the Philippines and Sri Lanka. For example, India Development Bonds (IDBs), Resurgent India Bonds (RIBs) and India Millennium Deposits (IMDs) raised, respectively, US$1.6 billion, US$4.2 billion and US$5.5 billion in 1991, 1998 and 2000 (Ketkar and Ratha, 2007). On the other hand, approximately US$254 million has been pledged so far to the Adaptation Fund, of which only 13.7% has actually been received for projects in Asia. China, India and Indonesia accounted for 16% of these funds (Sobhan, 2014).

The above review of the empirical evidence of the growing economic prowess of the Southern countries indicates their increasing potential to contribute to improved performance of the global economy.

2.1. Intra-South economic exchanges

The growing economic potential of the Southern countries indicates their capability to support each other. Indeed, the numbers presented in Table 4.2 reveal the increasing intra-South economic interactions in terms of FDI, remittances, exports and imports. The table indicates that a sizeable share of global FDI flows is taking place among the Southern countries. For example, while intra-South FDI flows accounted for about 12% of the global total in 2000, the corresponding figure for 2013 was more than 32.2%. A similar upwards trend may be noted in the case of remittance flows from expatriate workers – the figures suggest that an overwhelming share of the remittance income received by the Southern countries originates within the South. In 2000, about 60% of total remittance income by Southern countries was sourced from the South, while the corresponding figure for 2013 was more than 69%.

Table 4.2. *South-South economic exchanges*

Items	Years			
	2000	**2005**	**2010**	**2013**
FDI (% of global total)	11.8	15.6	28.6	32.2
Remittances (% of global total)	59.7	65.3	68.6	69.1
Exports (% of Southern total)	40.5	45.9	54.8	58.5
Imports (% of Southern total)	43.6	52.3	57.1	58.8

Source: UNCTAD database (http://unctad.org/en/Pages/Statistics.aspx).

In the case of exports and imports of goods, Southern countries are expanding their intra-group trade relationships. Currently (in 2013), about 58.5% of total Southern exports are finding markets in the South, while a decade back (in 2000) this share was 40.5%. In the case of imports, the corresponding shares increased from 43.6% in 2000 to 58.8% in 2013.

Further evidence of the expansion of South-South economic links may be found in the deployment of new sources of finance, including SWFs. Non-government organisations (NGOs) from the South, such as BRAC International (headquartered in Bangladesh), are also contributing to South-South cooperation.

As the Southern countries gain a stronger foothold in the global economy, the international development community is placing enhanced demands on them. These enhanced demands have been accompanied by rising expectations in the less fortunate Southern countries of the strengthened developmental role of the emerging economies. This dual trend has, in many ways, provided the backdrop for the design of the implementation of the post-2015 international agenda.

3. International cooperation documents on SSC

In the literature, the first International Conference on Financing for Development, held in Monterrey in 2002, is often considered a point of departure for the analysis of the dynamics of global development cooperation. South-South cooperation was mentioned in two articles of the Monterrey Consensus. In the first instance, regarding mobilising domestic financial resources for development, the Consensus called upon SSC to exchange views on 'successful strategies, practices and experiences' and for the replication of such views. On the second occasion, in connection with strengthening institutional financial and technical cooperation, SSC was cited as a delivery tool for assistance (United Nations, 2002).

Curiously, the Paris High-Level Meeting on aid effectiveness – held only three years after Monterrey in 2005 – had nothing to say on SSC.

In 2008, there were two high-level events on FfD – one producing the Accra Agenda for Action (AAA), and the other the Doha Declaration. The AAA highlighted the role of SSC in demand-driven and designed capacity development initiatives, as well as in servicing the need for experience-sharing among developing countries. Moreover, the AAA underscored the principles of non-interference, equality, mutual respect, cultural diversity and local content

(OECD, 2008). It also encouraged SSC to use the principles espoused by the Paris Declaration of 2005 as a point of reference. The Doha Declaration, reiterating most of the above-mentioned issues, stressed the importance of increased support for South-South trade expansion initiatives (United Nations, 2008).

At the Fourth High-Level Forum on Aid Effectiveness, held in Busan in 2011, SSC received more elaborate treatment. Through 11 articles and sub-articles, the Busan outcome document not only emphasised the shared principles of development cooperation to achieve common goals, but also elaborated on the features distinguishing SSC from traditional North-South cooperation, which include diversity of approaches and non-substitutability of contributors. Busan also welcomed new donors from the South, while at the same time pointing out the need to improve the quality and effectiveness of its development cooperation. In the articles specifically dedicated to SSC, the outcome document of the Busan conference underscored the usual areas of SSC, including experience-sharing and peer learning (OECD, 2011).

South-South cooperation possibly received its most elaborate elucidation to date at the Mexico High-Level Meeting on the Global Partnership for Effective Development Cooperation (GPEDC) in 2014. Along with the traditional reiteration of the differentiating principles of SSC operations, the GPEDC outcome document called for ensuring 'transparency and accountability to each other' and, connected to this, emphasised the need for SSC partners 'to improve the availability of information on the scope, results and impacts of their cooperation actions'. Furthermore, it encouraged initiatives undertaken by the South to deepen their understanding of the nature and modalities of SSC, and the ways and means of enhancing its development impact. The document singled out the middle-income countries as important providers, as well as recipients, of SSC inputs. It also welcomed knowledge-sharing among Southern countries and emphasised regional approaches to SSC, the engagement of public and private stakeholders in it, and the support of multilateral organisations for it. The GPEDC Communiqué also recognised the role of civil society organisations (CSOs) as development actors in their own right and committed to strengthening the contribution of CSO practices to development cooperation (GPEDC, 2014).

The above review of the outcome documents of a number of important international meetings on FfD leads us to conclude the following. *First,* all of these documents have acknowledged a unique set of guiding principles and the operational modalities underpinning the SSC regime. *Second,* in all cases, capacity-building through the sharing of knowledge and mutual learning have been identified as the major tools for SSC. *Third,* in the recent past, Southern countries have been mentioned as an additional and complementary source of financial and technical resources. *Fourth,* the issues related to the transparency, accountability and effectiveness of SSC have gained prominence. *Fifth,* albeit on a voluntary basis, SSC is being called upon to use the operational principles of the OECD as the reference point. *Sixth,* the role of the non-state actors (e.g. CSOs and the private sector) in SSC has also found recognition in the most recent documents.

3.1. Post-2015 documents

In view of the above-mentioned evolution of the global understanding of SSC, the current discourse on the post-2015 international development agenda is focusing on the possible contributions of SSC to the delivery of the emerging set of SDGs. The SDGs are supposed to be universal, transformative, inclusive and integrated in nature. As is known, the outcome document of the Open Working Group (OWG) on SDGs has come up with 17 Goals and 169 Targets characterising the post-2015 agenda. In the OWG's document, SSC has been considered a means of implementation (MoI), as it has been mentioned under Goal 17 "Strengthen the means of implementation and revitalize the global partnership for sustainable development". As part of this Goal, the role of SSC has been conceived under the sections on technology and capacity-building.

As Table 4.3 suggests, to implement the SDGs, SSC will be enhanced to improve access to science, technology and innovation, and to improve knowledge-sharing. It has been envisaged that SSC will contribute at the UN level to operationalising a global technology facilitation mechanism (yet to be agreed upon). The OWG document also indicates the need for a strengthened role of SSC in supporting the national plans of developing countries to implement all of the SDGs. Accordingly, the OWG has assigned a relatively modest role to SSC, which is reflective of the fine political balance underpinning the current understanding regarding the common, but differentiated, rights and responsibilities of the development actors in the emerging global partnership framework.

The Third Conference on FfD will take place in Addis Ababa in July 2015, prior to the adoption of the SDGs at a UN Summit in September 2015. The Addis Ababa Conference is supposed to work out the financing and other MoIs of the post-2015 agenda. The 'Elements' of the Addis outcome document were released recently (dated 21 January 2015) and SSC was mentioned therein under the 'Building Block' on international public finance. It can be observed from Table 4.4 that the further strengthening of SSC in support of sustainable development, as a complement to North-South cooperation, has been identified as one of the 'challenges' for implementing the SDGs.

Table 4.3. *Goals and Targets related to SSC according to the Open Working Group*

Goal	Section	Targets
Goal 17. Strengthen the means of implementation and revitalize the global partnership for sustainable development	Technology	17.6 Enhancing North-South, **South-South** and triangular regional and international cooperation on and access to science, technology and innovation and enhancing knowledge sharing on mutually agreed terms, including through improved coordination among existing mechanisms, in particular at the United Nations level, and through a global technology facilitation mechanism when agreed upon.
	Capacity-building	17.9 Enhancing international support for implementing effective and targeted capacity-building in developing countries to support national plans to implement all the sustainable development goals, including through North-South, South-South and triangular cooperation.

Source: United Nations (2014).

Table 4.4. *Policy related to SSC according to Addis Elements*

Building Block	Challenge	Suggested Policy
C. International public finance	Further strengthening South-South cooperation and triangular cooperation in support of sustainable development, as complements to North-South cooperation	Strengthening South-South cooperation and triangular cooperation: • Southern providers increase their contribution to international public financing of development, guided by principles of South-South cooperation. • Southern providers strengthen the systematic collection of data and evidence on South-South cooperation. • The international community strengthen the United Nation system's support to South-South and triangular cooperation.

Source: United Nations (2015b).

In this regard, the 'suggested policies' in the 'Elements' for Addis Ababa include the following. *First,* the Southern providers are to increase their role in international public financing. *Second,* the systematic collection of data and evidence on SSC has to be strengthened. *Third,* the international community will enhance its contribution to the UN's system of support for SSC. Admittedly, the first draft of the Addis Ababa outcome focused on a small, albeit important, set of policy variables to incorporate SSC into the broader global partnership framework. It is now to be seen whether the inter-governmental negotiation process will come up with measureable indicators to monitor the contributions of SSC to achieving the SDGs in the developing countries.

4. The upcoming opportunities and challenges

The 'coming of age' of SSC has also brought to the forefront a set of 'second generation' issues related to the opportunities and challenges SSC is facing in the context of the post-2015 agenda. Indeed, articulating and addressing these issues has become pertinent in order to expand and realise the powerful ideas that inform SSC, as well as to improve the revealed practices of this particular form of international development cooperation.

The obvious opportunities for a more substantive role for SSC in the emerging framework of international development cooperation emanate from the strengthened position of the Southern countries in the world economy. The expanding economic strength of the Global South has created, on the one hand, opportunities for it to contribute more forcefully to the development of the low and middle-income developing countries. On the other hand, the economic momentum in the Southern countries is providing them with leverage to redefine some of the basic rules of the game of the OECD-centred development cooperation framework. It is now to be seen how proactively the Southern negotiators, exploiting their newly acquired advantages, engage in shaping the post-2015 global partnership arrangement.

The challenges confronting the Global South in the context of the post-2015 agenda may be seen to form three clusters.[3]

First, the ideas and practices underpinning the SSC paradigm need to be provided with more clarity and coherence. With the expanding role of SSC in the global economy, the process and its manifestations are in need of reconceptualisation in order to develop a theoretical construct based on a common set of guiding principles underpinning the process. It is often stated that the underlying principles of SSC, among others, include South-South solidarity and partnership, respect for national sovereignty, selection of demand-driven projects and national ownership. It is often underscored that the contributions made in this regard are voluntary and not related to colonial part of the providing country. Thus, an analytical construct has to be put in place that can accommodate these principles in an integrated framework. Such a framework should be able to relate itself to a universal, transformative and inclusive post-2015 agenda.

3 These challenges have been mentioned elsewhere as 'second generation issues' of SSC (Bhattacharya, 2014).

Second, careful scrutiny of the incidence and episodes of SSC reveals that a framework and a toolbox have to be agreed upon that would go beyond 'knowledge-sharing' and 'capacity-building', and venture into new issues such as flows of interactive and blended finance. Improvements in the collection of data on SSC will be helpful in establishing the comparative effectiveness of the SSC model. To monitor the progress achieved by SSC in the post-2015 period, one will have to define the general conditions under which SSC takes place, and the contextual parameters under which the cooperation becomes 'successful'. The challenge is to develop the performance indicators for these conditions. Thus, it will be very helpful if a framework for the assessment of SSC can be designed to evaluate the effectiveness of the current practices of SSC against economic, social, environmental and governance indicators envisaged by the post-2015 agenda.

Third, one of the crucial challenges relating to SSC in the post-2015 period will be defining its relationship with the emerging regime of international development cooperation. In the near future, can one expect to see the emergence of a universal international development cooperation system whereby the SSC model and the Development Assistance Committee and OECD-centred aid regime will leverage each other to create greater development impact? Improving our current understanding of the efficacy of South-South-North triangular cooperation has also become important. A critical question in this regard is whether the traditional Northern actors will gradually abdicate their global obligations and commitments in favour of the emerging South, putting the latter under disproportionate pressure. In short, the creation of an integrated and universal global development cooperation framework in connection with the implementation of the SDGs will pose a major challenge.

It is expected that the international development community will engage intellectually in exploring these and other emerging issues concerning SSC in the post-2015 period. However, it will be quite appropriate for researchers and analysts in the Global South to take the lead in realising the above-mentioned opportunity and mitigating the associated risks.

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5

Triangular Cooperation as an Effective Tool for Strengthening International Knowledge Sharing

Hiroshi Kato and Masato Tokuda[1]

1. Introduction

In this chapter, we will put forward two arguments. First, we will argue that a new type of international cooperation will take on ever-increasing importance as we move into the post-2015 era. This new model is exemplified by horizontal cooperation through various networks, and the sharing of practical and local knowledge among a range of actors. Second, we will argue that one important pathway towards achieving such international cooperation will be through the expansion of triangular cooperation (TrC).[2]

1.1. The changing global landscape and ODA

'Official development assistance [ODA] is dying' is a phrase heard increasingly often in the international arena today (Severino and Ray, 2009, p. 1), and perhaps not without foundation. One reason for this shift is the increasing role of the private sector in the development of the world's poorer countries, particularly when compared with the declining importance of 'official' assistance. In terms of financial flows, private financial resources flowing into developing countries have long surpassed those provided by ODA, and this trend is unlikely to be reversed in the future. Moreover, in terms of knowledge sharing, the traditional mode of cooperation through ODA is increasingly being challenged, with the role of the private sector taking on greater importance in knowledge sharing through trade and technical cooperation.

Also gaining momentum is the recognition of the role of knowledge as an important resource for development – a resource as important as, if not more

1 The views expressed in this chapter are those of the authors and do not necessarily represent the views of the organisation with which they are affiliated. The authors express their thanks to Koji Yamada for his comments on and contributions to the earlier draft of the chapter. All remaining errors are the responsibility of the authors.

2 There is no established definition of triangular cooperation (OECD, 2013). In this chapter, we use the term to refer to Southern-driven partnerships between two or more developing countries supported by one or more developed countries or multilateral organisations.

important than, financial resources.[3] Indeed, the outcome document of the Busan High Level Forum on Aid Effectiveness (OECD, 2011) highlighted the importance of knowledge. Technical cooperation as part of traditional ODA is also being challenged. Fengler and Kharas (2010) argue that 'the old model of flying-in overseas experts to dispense policy prescriptions should be replaced by a continuous knowledge exchange that makes the best use of local talents.' If this is our way forward, there is no doubt that the traditional model of knowledge transfer must change.

The final and perhaps most important reason for questioning the role of traditional ODA is the changing power distribution among the countries of the world. The conventional dichotomy of the developed 'North' and the developing 'South' is gone, and the perceived superiority of the North over the South is disappearing. This irreversible move is symbolised by, among others, the changing roles of the G8 and G20 and the emergence of new financial institutions like the New Development Bank (formerly called the BRICS Bank) and the Asian Infrastructure Investment Bank. At the same time, countries that have traditionally been categorised as 'the South' have become more diverse. Some countries are recording remarkable, continuous economic growth, while others stumble behind, especially those plagued by violent conflict. There is no longer a group of homogeneous countries that can be categorised as belonging to the South.

1.2. Creation of a horizontal cooperation architecture

All these arguments point to the obsolescence of the current ODA system, a point with which we also agree. However, we do not believe that this argument directly leads us to the conclusion that ODA should be abolished outright. Rather, we believe that with modification, ODA (in whatever shape it may take in the future) will continue to have a role to play in the creation of an international cooperation system for the twenty-first century. We offer three reasons for this argument.

First, despite the primacy of the role of the private sector in world development, markets obviously do not cover everything, a fact that applies not only to the transfer of monetary resources but also to the transfer or sharing of knowledge. This implies that knowledge transfer/sharing outside the market mechanism, i.e. through public channels, will remain relevant in the coming decades. The range of knowledge to be transferred/shared outside the market mechanism is enormous; it includes, to name just a few key factors, knowledge of global issues, knowledge of the management of the public sector, and local knowledge that is not usually subject to market transactions.

Second, South-South cooperation (SSC), a mode of cooperation that it is believed will play an important role in the twenty-first century, may not develop as rapidly as people might wish, particularly if it continues without adequate intentional and continuous international support. In fact, while a significant number of Southern countries are now commencing SSC, they remain only a

3 Financial resources and knowledge are mutually compatible and mutually reinforcing.

minority, representing only a tiny fraction of the whole set of countries in the South. SSC might be able to develop faster with external support and, as will be discussed later, traditional donors can also play a role in this respect through the use of TrC models to boost SSC.

Third, and a point somewhat related to the previous two points, is the fact that, though perhaps not increasing fast enough, there are increasing numbers of developing country governments that are engaging in systematic efforts of knowledge transfer to other countries, as part of their contribution to SSC.[4] However, knowledge transfer/sharing is a more complex and difficult process than is usually understood, and there is no guarantee that these 'novice' actors will become effective knowledge providers or facilitators. In other words, if these emerging actors are to become effective facilitators of knowledge transfer, they must be equipped with appropriate methods, tools and resources. Luckily, a knowledge base has been amassed by traditional ODA providers over the years for these emerging knowledge providers to learn from. We argue that with this body of skills, knowhow and experiences – both successful and not so successful – traditional ODA providers can play a significant role in boosting SSC.

Based on these considerations, this chapter will argue that traditional ODA donors can and should play more positive roles in the twenty-first century, not by trying to maintain the status quo but by engaging in the process of creating a new architecture of international cooperation.

This chapter is organised as follows. In Section 2, we provide a brief overview of the concepts that this chapter will draw on, i.e. those related to knowledge management and, more particularly, knowledge transfer/sharing, along with the literature on social networks. In Section 3, we look at the expectations for and challenges of implementing SSC, with particular emphasis on the factors that are hindering smooth knowledge transfer/sharing among the Southern countries. Section 4 will discuss the possible advantages of TrC in boosting South-South knowledge transfer/sharing, based on the concepts reviewed in Section 2.

2. Conceptual frameworks

2.1. Knowledge transfer/sharing[5]

For our discussion of knowledge transfer/sharing, we rely on findings by Duan *et al.* (2010) and Cummings (2003). Based on a literature review as well as on an original survey, Duan *et al.* argued that there are ten key factors that can affect success in transnational knowledge sharing. These can be grouped into four clusters: actors, context, content and media. The range of factors encompassed by the actors of knowledge sharing includes culture awareness,

4 Most countries, when they start to engage in South-South cooperation, begin with technical cooperation. For more details, see OECD (2012) and Lengyel (2011).

5 So far, we have been using the term 'knowledge transfer/sharing' without defining either specifically. Various authors have used the terms 'knowledge sharing' and 'knowledge transfer' synonymously (Duan *et al.,* 2010). Hereafter, we will use the term 'knowledge sharing,' to refer to 'the means by which an organisation obtains access to its own and other organisations' knowledge' (Cummings, 2003, p. 2).

motivation, knowledge distance, trust and openness. In terms of the factors relating to the context in which knowledge sharing occurs, Duan *et al.* argue that the relationship between, and selection of, appropriate partners is important. Content wise, they argue that objectives and focus were found to be key factors, that is, organisations must have clear objectives and focus on what knowledge can be shared and how. In terms of the media, they point out that language and the channels used for sharing are also key factors of the transfer.

A similar framework for knowledge sharing is found in Cummings (2003). Based on an extensive literature review, Cummings broadly identifies five primary contexts that can affect successful knowledge-sharing implementations. They are: (1) the relational context (the relationship between the source and the recipient), (2) the knowledge context (the form and location of the knowledge), (3) the recipient context (the recipient's learning predisposition), (4) the source context (the source's knowledge-sharing capability), and (5) the environmental context (the broader environment in which the sharing occurs).

While the two papers differ from each other in the way they frame the subject, by combining them together and examining their discussion in the context of South-South knowledge exchange, we can gain some insights on the advantages of South-South knowledge sharing as well as factors that are likely to be lacking in it. On the positive side, proponents of South-South knowledge sharing can claim, generally, that Southern nations tend to have a better chance of possessing the following favourable factors, given the oft-claimed similarities of the situations/contexts of the countries/organisations and their sense of trust and solidarity:

1. Actors
   - Actors tend to be aware of the cultural background of their partners.
   - Actors who share a similar level of knowledge can engage in effective knowledge sharing.
   - Actors can develop a sense of trust, given their close relationships.
2. Context
   - Generally, the short geographical distance between the parties can alleviate the difficulties, time requirements and expenses of meeting face-to-face and communicating.
   - Knowledge sharing is easier, because knowledge is often meaning- and value-based.
   - The social similarity of the parties will make their communications easier, and this will allow for greater sharing success.
3. Content
   - Organisational learning tends to be enhanced because the knowledge gap between the source and the recipient is not so great.

- In many situations, a significant component of an organisation's knowledge is embedded in people, and at its simplest, the sharing of people-embedded knowledge would require only the movement of people between units, since they would carry the knowledge with them.

4. Media
   - Sharing a common language makes the sharing of knowledge easier.

However, some factors, such as the following, do not seem to be readily available in standard South-South knowledge transfer settings:

1. Actors
   - A knowledge source that is equipped with a strong learning culture, strongly motivated to work as a knowledge source, and equipped with the knowhow and the body of knowledge is needed for effective knowledge transfer.
   - A recipient with sufficient capability with respect to accepting, retaining and nurturing new knowledge is necessary.
2. Context
   - A systematic meta-knowledge of where to find the appropriate knowledge is required.
   - Systems to motivate a multitude of actors, both within the country and across countries are necessary.
3. Content
   - The body of knowledge to be shared may not be limited only to locally available knowledge, but may include knowledge only obtainable elsewhere from other sources. This includes, for example, knowledge embedded in products, tools and technologies. To be effective, the knowledge-sharing process must cover these bodies of knowledge as well.

With this quick review of the literature and models of knowledge sharing, we argue that while South-South knowledge sharing seems to have some intrinsic and important advantages, success is often impeded by the lack of some necessary factors, notably by the lack of competent actors in knowledge sharing and an enabling environment that connects such actors. Moreover, we contend that TrC, or any similar intervention from external actors, can provide a way for countries of the South to overcome these obstacles. We will return to this issue in greater detail in Section 4.

2.2. Social networks

One reason that TrC can play a role in facilitating South-South knowledge sharing is that it can promote the formation of *networks* among countries and actors in the South. 'Social networks' can generally be defined as a social structure made

up of a set of social actors (such as individuals and organisations) that pursue repeated, enduring exchange relations among the actors. When referring to network organisations, Podolny and Page (1998) argue that they have a number of functions and benefits of network forms of organisations, as listed below.

1. The network organisation can foster learning by promoting the rapid transfer of self-contained pieces of information as well as by encouraging the novel synthesis of information that are qualitatively distinct from the previous information. With this second approach, the network becomes the locus of innovation.
2. The network organisation makes it possible for those actors with low recognition in society to enhance their social recognition, by associating through the network with actors with higher levels of social recognition.
3. The network organisation lowers transactions costs thanks to the reliance on trust among its actors.[6]

We argue that these advantages of the network organisation are worth tapping into, if the spirit of South-South knowledge exchange is that of mutual learning, equitable relations, and anti-bureaucratic management.

3. SSC and knowledge sharing: Status quo and challenges

3.1. Knowledge sharing among the Southern countries: Potential

As has been discussed by many analysts, there is increasing interest in South-South cooperation and, in particular, the potential role it can play in promoting knowledge sharing and mutual learning. The outcome document from the 2011 Busan High Level Forum (OECD, 2011) shows how internationally significant SSC and knowledge sharing have become. The document highlighted their importance as follows (emphasis added by authors):

> '31. We recognise that many countries engaged in South-South cooperation both provide and receive diverse resources and expertise at the same time, and that this should enrich cooperation without affecting a country's eligibility to receive assistance from others. We will *strengthen the sharing of knowledge and mutual learning* by:
>
> a. Scaling up – where appropriate – the use of triangular approaches to development cooperation.
>
> b. Making fuller use of *South-South and triangular cooperation*, recognising the success of these approaches to date and the synergies they offer.

6 Network organisations have disadvantages, too: their activities tend to be unstable; the learning outcomes may be dissipated and lost over time if the organisation is not properly equipped with systems to store knowledge; their organisational structure could become progressively more unstable, making it difficult for the organisation to realise long-term development; and they could be dependent on other organisations (Wakabayashi, 2009).

c. Encouraging the development of *networks for knowledge exchange*, peer learning and coordination among South-South cooperation actors as a means of facilitating access to important knowledge pools by developing countries.

d. Supporting efforts to strengthen local and national capacities to engage effectively in South-South and triangular cooperation.'

In fact, the importance of knowledge sharing among the countries in the South cannot be overemphasised, for two reasons. First, there are certain types of knowledge that are only sharable through SSC, namely, the body of knowledge available only in the South. Obviously no North-South knowledge transfer can do this. A typical example consists of measures for disaster risk reduction. A variety of such measures, ranging from the most sophisticated and expensive to the simplest and the least expensive, may be put forward for consideration. But whereas rich countries can afford to apply the former types of knowledge and knowhow, poorer countries, being unable to apply such expensive measures, must adapt whatever knowledge and technologies may be available locally, and it is through SSC that this type of knowledge can be transferred and shared. One example of such knowledge sharing can be found in the case of the BOSAI disaster prevention project, which has supported the development of capacity to promote community-based disaster risk management in six countries in Central America, utilising a region-wide cooperation framework (Hosono, 2012).

Second, sharing those bodies of knowledge that are available only in the South will gain increasing importance. If, as Tanaka (2012) argues, the recent rapid growth of emerging economies has been driven by knowledge developed only recently rather than the knowledge accumulated during the nineteenth or twentieth centuries in Europe and America, then countries aspiring to follow suit will look to those newly emerging countries in the South for useful experiences rather than to today's developed countries. As the number of countries gaining middle-income country status increases, so will the need to transfer their developmental experiences to other countries.

3.2. Obstacles to SSC

Despite these obvious advantages, SSC is unlikely to grow as quickly as is desirable.[7] There are some obvious impediments to the optimal expansion of SSC. Foremost is the fact that the business of international cooperation – be it North-South or South-South – is a complex process that consumes a lot of resources. Countries aspiring to be a cooperation provider must have at their disposal policies, regulations, institutions, human resources, communication channels with their partner countries and evaluation systems, to mention just a few aspects, and all of these require a lot of resources. This could be a significant impediment even for countries with strong aspirations.

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7 The absence of a clear definition and statistics makes it hard to provide quantitative on this point. Though rather outdated, the 2006 OECD report lists 14 non-DAC member countries as SSC providers.

In addition to the problem of cost there is another impediment for aspiring countries, even rich ones: the need to accomplish effective knowledge sharing, which is a difficulty intrinsically embedded in knowledge sharing.

As discussed in Section 1, knowledge sharing is a complex and non-linear process, and countries have to have appropriate systems, organisations and human resources in place, as well as a systematised body of knowledge – including the meta-knowledge on how to share knowledge[8] – to be effective knowledge facilitators. To put this last point more specifically, countries must first identify what kind of knowledge they have at their disposal that is worth being shared with their Southern peers. They then have to systematise this body of knowledge in such a way that it can be shared with, and transferred to, their partners in an effective manner. Effective knowledge sharing is possible only when bits and pieces of knowledge – many of which are examples of tacit knowledge – are systematised and translated into *explicit* knowledge. This requires extensive work and forethought, and not many countries have the capacity to do it with ease. And of course, to actually implement the knowledge sharing, including follow-up activities, institutions are necessary, which again requires professional skills and knowhow. All of these are difficult challenges, not easily overcome without abundant resource allocation in conjunction with strong commitment from the high-level leadership of a country.

Another point worth mentioning, as a corollary of the previous two points, is the potential problem of oligopoly of SSC or SSC activities dominated by a small number of economies in the South, as the economic and political polarisation of the countries in the South progresses. We may wish to avoid this, first, because the dominance of SSC by a small number of the Southern countries may result in the creation of 'North-South'-like relationships within SSC; and second, if dominated by a small number of bigger and more powerful countries, SSC is unlikely to be able to take advantage of the vast knowledge that remains unshared in numerous 'smaller' or poorer countries of the South.

4. Potential for TrC to boost SSC as a channel of knowledge sharing

In Sections 2 and 3.1, we argued that South-South knowledge sharing does have strong potential when considering the actors, context, content and environment. In Section 3.2, however, we pointed out that SSC is not developing as fast as we would like it to, due not just to financial and other resource constraints but also to the difficulties inherent in the process of knowledge sharing. Based on this recognition, and drawing upon the experiences accumulated at JICA and other development assistance agencies, we now argue that TrC can play a significant role in overcoming these challenges.

8 One of the most important initiatives for enhancing this kind of meta-knowledge and capacities for knowledge sharing is the Country-led Knowledge Hub initiative promoted by the World Bank in collaboration with several countries, including Indonesia, Japan and Korea.

4.1. Playing the role of knowledge brokers

Through TrC, non-Southern actors can play the role of knowledge broker, thereby reducing the initial cost of knowledge sharing. Experience shows that the biggest hurdle to effective knowledge sharing, at least in its early phases, is matching up the demand for knowledge with the supply. However, though it seems somewhat counter-intuitive, countries in the South often find it difficult to know where to look for the knowledge they are seeking, or where and in what ways the knowledge they possess will be of use to other countries. This is where international organisations and/or bilateral cooperation agencies can play a role, with their knowledge of where knowledge is available and whose needs it will satisfy.[9]

One good example is a UNDP project linking the Caribbean and Pacific countries. The project was initiated by a UNDP officer who had been working in the Caribbean islands and, immediately after being transferred to the Pacific region, began working as a coordinator to link the two regions that are geographically far apart, but have many common features and challenges (Bernard and He, 2013).

4.2. Enhancing the capacity of knowledge providers

TrC can be of service to countries that aspire to be involved in SSC-based knowledge sharing, either through individual projects or by assisting countries in policy formulation at the national level. With regards to individual projects, the contribution of TrC to South-South knowledge sharing has been proven effective, especially in nurturing the capabilities of organisations that eventually grow into knowledge facilitators. There is a long list of projects that have taken advantage of the achievements of previous North-South cooperation, using the knowledge gained through it as a resource for South-South knowledge sharing. Here, it is worthwhile to look briefly at the case of a TrC cooperation project between Germany, Mexico, and Bolivia. Germany had been cooperating with Mexico's National Water Commission to develop its capacity since 1997. In order to capitalise on the cooperation and the accumulated capacity at the Mexican National Water Commission, the two countries commenced a triangular project with Bolivia in 2011. According to the mid-project report, the project has been successful in promoting mutual understanding between experts from Mexico and Bolivia (Baumann, 2012). Japan also has a good track record in cases where organisations that have been receiving its cooperation reach a point where they have sufficient capacity for knowledge sharing, and have subsequently carried out a core function in a TrC project for South-South knowledge sharing. Such organisations have come to acquire a range of skills and knowledge needed for effective knowledge exchange – systems, knowhow, human resources

9 This observation could perhaps be explained by using the concept of structural holes developed by Burt (1995).

and 'knowledge on knowledge' – during their own capacity-building process supported by Japan.[10]

Indeed, TrC can be useful in helping developing countries to build the capacities of some of their core organisations, or 'centres of excellence' (COEs). However, it does not stop there. Traditional donors, while supporting the capacity development of the COEs through TrC, can simultaneously help the country to develop a national system of knowledge sharing. Indonesia is a good example in this regard. The country has succeeded in developing a strong capacity within many of its organisations, but the accomplishments have not stopped there. It has also started to develop a national system for international knowledge transfer. International donors were allowed to play a role here, too, and this cooperation can constitute a component of TrC, furthering the promotion of SSC albeit indirectly.

Although Indonesia has a long history of being a leader in South-South cooperation, with efforts dating back to the Bandung Asian-African Conference in 1955, it was only fairly recently that Indonesia began its efforts towards building up its capability as a South-South knowledge transfer provider. The country has taken a systematic approach to doing this, gradually developing its national system of development cooperation in a process that has entailed several actions. The first has to do with the identification of knowledge that they would eventually share with others. The Indonesian government started by identifying the body of knowledge at its disposal and establishing what knowledge was believed to be worthwhile for sharing with other developing countries. The government chose several areas of knowledge – such as agriculture, maternal and child health, disaster risk reduction and child health care – as those in which the country has accumulated usable knowledge relevant to other developing countries. It then went on to systematically develop their body of knowledge to make it sharable with their potential partners. At the same time, the Indonesian government has systematically made efforts to develop capable institutions in collaboration with its partners, which later came to serve as centres of excellence in extending knowledge transfer. Further, the government went on to develop institutional frameworks of South-South cooperation, including national policies and regulations.[11]

All of these endeavours were possible thanks to Indonesia's strong commitment to South-South knowledge exchange. However they also were facilitated by support from external actors, including both international organisations such as UNDP, FAO, UNFPA, and ESCAP, and bilateral donors including Japan and Germany. They have been providing the Indonesian government with various resources that enable the country to promote South-South knowledge sharing through various training programmes. It is through the implementation of

10 For details of such cases see, for example, Inamura (2012), Saito (2012), Hosono (2013), Kawaguchi (2013) and Shimoda (2013).

11 These include the Grand Design and the Blue Print (for South-South cooperation) as a policy framework, works in the development of human resources, and the application of a policy framework to pilot projects. For more details, see Shimoda and Nakazawa (2012) and Hosono (2015).

these programmes that the government has accumulated skills, knowledge and knowhow on how to provide effective knowledge transfer.

So far, we have discussed the role of TrC in both helping the capacity development of COEs and in helping countries to develop a national system of knowledge sharing, taking Indonesia as an example. However, it is not just in large countries like Indonesia that TrC can help to develop a country's potential as a knowledge provider. TrC, if managed wisely, can also tap into the latent potential of countries that are considered unlikely to play a role as a knowledge provider, typically small or poor countries.

A triangular technical cooperation project facilitated by the Netherlands provides a good example of this. The project attempted to combine the knowledge of three countries, all of which are small and relatively poor: Bhutan, Benin and Costa Rica. Facilitated by a triangular framework covering sustainable tourism, sustainable production/consumption chains, biodiversity and sustainable energy, participants from each of the three countries started to get to know each other, to identify their problems, and to identify the knowledge and experiences available in their respective countries that seemed applicable to the problems of their partner countries. As of 2011, four years after its inception, there has been an active transfer of knowledge through the project, enabling each of the three countries – none of which is large or rich – to act as a knowledge provider.[12]

Another example of a case where even a small or poor country can share their precious knowledge for development with others can be found in a triangular solid waste management project supported by JICA and involving South Pacific island countries. The project has taken full advantage of regional good practices accumulated over the years, including landfill improvements in Samoa and Vanuatu, landfill improvement and recycling in Palau, and the promotion of the 3Rs (reduce, reuse and recycle) in Fiji. Here, even small countries can share their good practices with their peer countries.[13]

4.3. Helping to develop networks of knowledge sharing

We now turn to another possibility for TrC to promote South-South knowledge sharing: helping to develop *networks* among the actors in the South. Obviously, TrC can not only promote cooperation among three parties, as its name implies, but it can also be applied to cooperation projects involving a *network* of actors, extending the scope of cooperation far beyond merely three parties.

The advantages of networking for the countries in the South can be substantial, as briefly summarised in Section 2.2 above. To recapitulate, it can foster learning, it can provide actors with legitimacy or status from which they can derive economic benefits, and it can reduce transaction costs.

In addition to these advantages identified in the literature, several other advantages of network-type cooperation can be identified in the context of South-South knowledge sharing. First, members of a network of knowledge sharing can have access to a *variety* of pieces of knowledge made available by

12 For more details, see Gautam *et al.* (2013).
13 For more details, see Kano and Honda (2013).

its members, not just those that are provided by a single partner. Indeed, two heads are better than one, or four eyes can see more than two. This advantage of network-type cooperation has already been illustrated by the above example of cooperation on solid waste management involving the Pacific island countries; the project has enabled the participating countries to offer and exchange their local knowledge, and the participants were able to choose the kind of knowledge they found useful for their specific needs.

Similar cases abound,[14] but to give just one additional illustration, let us take the case of a network-type project on mathematics and science in Africa.[15] The purpose of the project was to develop effective in-service training systems for teachers and to enhance their classroom performance by introducing innovative teaching methods in mathematics and science. The project emphasised mutual learning among the practitioners of the participating African countries. Initially in this network-oriented project, the leading role in the mutual learning was played by Kenya, a powerful and relatively rich country in the continent. As the network and its activities developed, however, the position and role of Kenya within the network began to shift and countries other than Kenya, which had accumulated practical wisdom of their own, started to spontaneously share their knowledge and experiences with others (Ishihara, 2012).

The second advantage of networks is that they can facilitate active resource mobilisation, as Wakabayashi (2009) points out. In other words, while networks can encourage mutual learning as mentioned above, they can also make it possible for their members to take collective action towards their shared goals, while encouraging them to pitch in with the resources they have. One illustration can be found in a network-type cooperation project linking universities in Southeast Asia (Umemiya and Tsutsumi, 2007). In this project, participating universities united their resources and embarked on joint research on subjects of shared interest, achieving results that would have been impossible if pursued by individual universities.

Finally, network-type knowledge exchange encourages horizontal knowledge sharing, making it possible even for small, disadvantaged actors to play a role in knowledge sharing. This point was already touched on when we discussed the case of a project between Bhutan, Benin and Costa Rica – a small network of three actors – and the case of solid waste management in the Pacific.[16]

5. Summary and concluding remarks

There seems to be an international common understanding that the next-generation international cooperation architecture should be one that is more horizontal, involves more actors and emphasises a knowledge sharing that is more

14 For cases of knowledge sharing through networks see, for example, Honda (2012), Bernard and He (2013), Hasegawa (2013) and Kano and Honda (2013).

15 The project name is Strengthening of Mathematics and Science Education in Western, Eastern, Central and Southern Africa (SMASE-WECSA); for details, see Ishihara (2012).

16 Another good example of this is a project for better hospital management in Africa; see Honda (2012).

mutual and bi- or multi-directional than is the case with the present North-South cooperation. To achieve this, both today's developed and developing countries must join forces. Developed countries must try to restructure their cooperation while, for their part, developing countries must strengthen their efforts towards the promotion of SSC. Based on this recognition, we have argued that a practical way to bridge these efforts by developed and developing countries is to promote triangular cooperation (TrC). While SSC has many advantages, in many SSC settings some crucial factors for effective knowledge transfer are missing, and TrC can help developing countries fill these gaps by supporting them in building up their knowledge sharing capacity, and also by helping them to build up networks for knowledge sharing.

We have argued that by providing TrC, traditional donors can play the role of catalyst in helping their Southern partners to develop networks of mutual learning and knowledge sharing. The question that remains is: What specifically facilitates the formation of such networks for knowledge sharing? While admitting that more research is needed to justify our contention, we tentatively argue that the advantage of the traditional donors in this regard may be that through the years of ODA activities, they have developed extensive networks of practitioners in developing countries. Hence, they possess a body of knowledge on a great many countries and the kinds of problems they face, as well as on what knowledge is available for these problems and in what countries. As stated earlier, somewhat counter-intuitively, this kind of 'knowledge on knowledge' is not widely shared among the countries of the South, which do not engage in knowledge sharing as a matter of routine, and tends to be accumulated by the donors who have been engaged in international knowledge sharing over the years. Perhaps it is thanks to this knowledge that traditional donors can now play a role in facilitating knowledge sharing through networks.[17]

International cooperation in the post-2015 era must be based on partnerships, and perhaps, as Johnson and Wilson (2006, p. 2) argue, 'partnerships conceived as learning models that build on mutuality and difference offer the potential to challenge power relations'. To achieve this goal, countries must join forces, and one way of doing this is to promote South-South cooperation through triangular cooperation and to build up global networks of multidirectional knowledge sharing among development workers of every country.

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17 This argument could be further strengthened by employing the notion of network externalities, i.e. that per capita gain of a user/participant of a network increases as the number of participants increases. That is, an argument can be developed that in the context of South-South knowledge sharing, the traditional development cooperation agencies have broader networks of development, information and knowledge and are able, by offering TrC, to provide their Southern partners with the benefits of their network.

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6

The Future of Multilateral Development Banks in the Post-2015 Agenda Will Involve Fundamental Reforms

Benoît Chervalier[1]

The reform of multilateral development banks has become a necessity with the change in the development paradigm, which has accelerated in recent years. The President of the World Bank, Jim Yong Kim, assessed the scale of the challenge as soon as he took over the reins at the Washington institution in the summer of 2012, though not without some difficulty. A fundamental reform of the institution was launched to create a more coherent relationship between the Bank's different windows and a rapid series of appointments and departures were decided on, to help the organisation adapt to the new challenges and new areas of work it faced. This was just the start. In 2014, the Asian Development Bank, concluding that the existing model had reached the end of its life and in light of the economic success of many of its member countries, which had achieved middle-income status, decided to launch plans to merge its concessional and non-concessional windows. The African Development Bank is examining its own future, at a time when it has just launched an ambitious fund (Africa50) whose aim is to make infrastructure projects eligible for funding as a way of completing the continent's transformation. At the same time, emerging powers are continuing to advance and, at the 6th BRICS Summit in Brazil on 15 July 2014, announced the development of their own bank – initially called the BRICS Development Bank and now the 'New Development Bank' – with the aim of supporting greater financial and development cooperation between emerging countries. It has already announced that its head office will be in Shanghai and that its first president will be of Indian nationality. In the same vein, the launch of the Asian Infrastructure Investment Bank on 24 October 2014 heralds direct competition for the Asian Development Bank. It is therefore in everyone's interests to redefine the role of these development finance institutions and the objectives they intend to pursue.

This chapter focuses principally on multilateral development banks, which have a specific governance model and growth model that make them more sensitive to

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the fundamental economic changes the modern world has experienced since the start of the twenty-first century.

1. Historical perspectives

The history of the multilateral development banks dates back to the Bretton Woods Agreements, which founded the International Bank for Reconstruction and Development (later known as the World Bank) and the International Monetary Fund. The system therefore developed in parallel with the UN system, but with a distinct governance model. Development institutions linked to the UN system are characterised by a governance system in which each country has one vote, regardless of its economic power. Conversely, the Bretton Woods institutions, and the IMF in particular, are organised based on the relative economic power of their member countries. Whilst traditional economic powers are strongly represented because of the influence of history and the slow evolution of quota arrangements, their governance model is still characterised by a correlation between economic power and political representation (in the form of voting rights).

The system of multilateral development banks is a heterogeneous one, which includes institutions with distinct terms of reference and governance structures. One group is made up of the World Bank Group, the African Development Bank Group, the Asian Development Bank, the Inter-American Development Bank and the Caribbean Development Bank. A second group consists of sister organisations, often created subsequently and whose targets and governance structures vary, with a mandate that is more targeted to economic transition and support for already emerging and even developed economies. These include the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD) and the Council of Europe Development Bank. Finally, there is a third group, similar to the IFAD (International Fund for Agricultural Development), which is halfway between a UN institution in terms of governance and a multilateral bank in terms of operations. This chapter will look mainly at the first group.

The banks in the first group are structured in an almost identical way except for the Inter-American Development Bank. The others all have a concessional window in respect of public funding – namely, the International Development Association (IDA) for the World Bank, the African Development Fund for the African Development Bank, and the Asian Development Fund for the Asian Development Bank – targeting low-income countries, and a non-concessional window that provides funding for middle-income countries.[2] Some years later, private-sector windows were established, either as independent entities – such as the International Finance Corporation, which is part of the World Bank

2 Eligibility for either window is based on two criteria, namely whether the level of income per inhabitant exceeds the threshold revised annually by the World Bank (set at US$1,215 per inhabitant per year for FY 2014) and the country's creditworthiness. Countries have access to non-concessional resources (in practical terms, a higher volume of lending, at a higher rate than the concessional window but still more attractive than a commercial loan) provided they meet both criteria.

Group (1956) – or as a body that is directly incorporated into the institution, like the African Development Bank Group. The concessional windows were created in the 1960s for the purpose of providing grants or loans under highly advantageous terms, helping countries to fund part of their development without endangering their debt sustainability. Resources for these windows come from donor countries represented by Deputies through a process of replenishment every three or four years. Although these resources represent substantial sums[3] – particularly from the taxpayer's point of view – they are not enough to meet the level of investment needed for the economies of low-income countries to take off. Looking only at Africa and citing a well-known example, the resources allocated to low-income African countries in receipt of concessional finance – around 40 of the continent's 54 countries[4] – from the World Bank and the African Development Bank accounted for around US$11 billion a year over the period 2010-2013, whilst requirements are estimated at almost US$93 billion a year for the next ten years for infrastructure alone (World Bank, 2009).

2. An increasingly sophisticated system in an increasingly complex world

The 1990s, and the 2000s even more so, were characterised by the creation of several new international organisations, essentially specialist funds, generally in the area of health or the environment and combating climate change.[5]

At the same time, the (bilateral and thematic) trust funds run by multilateral development banks have proliferated, suggesting a need for rationalisation and overall coherence.[6] The total resources managed via these channels increased from US$11 billion in 2007 to US$20 billion in 2011, and the trend is continuing (World Bank, 2013b).

All of these elements have resulted in an unparalleled increase in complexity of the international development system, precisely at a time when the coherence of different actions and mechanisms was being highlighted during negotiations on the aid efficiency agenda.

As a result, the main issue is the relationship between the various development finance institutions and the pertinence of the division of labour between all the institutions and funds concerned.

These are not new questions. Such shifts are not simply a reflection of changing circumstances, but have been inherent from the outset. With 50 years' distance,

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3 During the last round of replenishments in 2013, the World Bank (IDA17) received US$26.1 billion in terms of direct contributions from donors and the African Development Bank (AFD13) US$5.8 billion.

4 The classification of low-income countries can vary slightly between institutions and depending on country reclassification or graduation processes. The African Development Fund classified 40 countries as low income as of 31 December 2013.

5 To cite just a few examples, the Global Environment Fund was created in 1991; the Global Fund to Fight AIDS, Malaria and Tuberculosis in 2002; the Unitaid initiative was launched in 2006; the Global Alliance for Vaccines and Immunisation (Gavi) in 2000; and the Green Climate Fund in 2010.

6 As of 31 December 2013, the World Bank had 700 trust funds (World Bank, 2013a), the African Development Bank had 25 multi-donor trust funds, the Inter-American Development Bank had 13 multi-donor trust funds and the Asian Development Bank had 52 such funds.

it is impossible not to be struck by the resonance and pertinence of the analysis in the fascinating memoirs of Liberian A. Romeo Horton, *For Country, Africa and My People*. The discussions between one of the key founding fathers of the African Development Bank ('the African Jean Monnet') and Robert McNamara, the President of the World Bank at the time, concluded unequivocally, in justifying the legitimacy of the creation of a regional development institution, that the African Development Bank would concentrate on regional integration projects, whilst the World Bank would target national projects. The African Development Bank and the World Bank clearly evolved quite differently, with both institutions funding national and regional projects.

Such redundancy was easier to tolerate in a more closed world, dominated by a small circle of economic powers, with enormous needs in terms of countries, sectors and geographical diversity. That is no longer the situation. An analysis by the Center for Global Development showed that by 2025, low-income countries eligible for concessional financing from the African Development Bank will, to all intents and purposes, be the same as those of the World Bank (Moss and Leo, 2011). The same redundancy is found at a sectoral level, since the multilateral development banks continue to intervene in areas for which specialist institutions have been created (World Bank, 2009). The overlap between structures now points to a need for rationalisation and a redefinition of tasks. The increasing complexity of the situation has also been driven by the direct links between countries caused by environmental challenges and efforts to combat climate change, thus transcending the simple financial and commercial relationships between states and organisations.

3. Concessional financing at the heart of the future of multilateral development banks

The primary role of development banks lies in eradicating extreme poverty. Their relevance therefore relates to the way in which they plan to tackle the challenges faced by low-income countries. A working group at the Center for Global Development, led by Jean-Michel Severino and Todd Moss, reported its findings in October 2012, suggesting a fresh approach to soft lending at the World Bank and, in particular, putting forward an iconoclastic recommendation not to fear a decline in IDA funding for future cycles and to plan for a transitional window (Severino and Moss, 2012).

The arguments in favour of maintaining a concessional financing window in the medium term are robust, as shown by a study commissioned by the German government in 2014 (Reisen and Garroway, 2014).

First, although several countries should emerge from the poverty trap by 2025, some 30 others are expected to remain in the low-income country category, i.e. below the threshold for gross national income per capita set each year by the World Bank, which was US$1,215 per inhabitant per year for 2014.[7] The pertinence of maintaining this classification is questionable in itself.[8] Most of

7 July 2014, Annex D, World Bank Operational Policies.

8 A specific study on renewing concessional financing will be published by the author in early 2015.

these countries will be in sub-Saharan Africa, an area that will also see the most significant demographic growth over the next ten years. In the same vein, 2013 saw the creation of working groups in response to the latest IDA17 discussions, focusing on the future of the Bank's concessional financing window, its replenishment process and the strategy the World Bank should pursue. The African Development Bank has followed suit, launching a Working Group in 2014 to focus on innovative resources for the African Development Fund.

Second, the estimate of the number of countries eligible for the concessional financing window does not take account of exogenous shocks, natural or health disasters or political and military crises, which have the potential to undermine or even stop growth in countries that are still structurally vulnerable. The development of the Ebola crisis in Guinea, Liberia and Sierra Leone shows the extent to which growth trajectories can still be fragile in this group of countries.[9]

Third, external resources only reach them to a limited or even marginal extent. None of them has access to the financial markets and none is likely to have access to them in the medium term; foreign direct investment and commercial trade are therefore still restricted. Concessional financing remains a significant source of predictable resources for them. It therefore seems that the existence of concessional financing windows remains relevant, even if they cannot provide sufficient resources to transform the economies of the countries they support.

Under these conditions, the difficulty lies in maintaining an overall approach in a world where responses and mechanisms need to be increasingly aligned with specific situations and countries to be effective. 'One size fits all' is no longer sufficient.

The existing system was built on common rules (one concessional and one non-concessional window) with identical referral criteria: concessionality rates were more or less identical across multilateral development banks[10] and countries' level of excess debt was the benchmark indicator for allocating resources to them (loans and/or donations, based on a traffic-light classification).[11] Recent changes show that each development bank is trying to differentiate itself. At its annual meeting in May 2014, the Asian Development Bank stated officially that it was examining how the two windows might be brought closer together in light of

9 A study by the World Bank in October 2014 estimated that the disease has already had a negative impact on growth in West Africa that could be as high as US$32 billion by the end of 2015, or 0.5% of the continent's GDP.

10 Rates are generally adjusted regularly, in line with negotiation rounds. During the IDA17 round, which ended in December 2013, and the AFD13 round, which concluded in September 2013, loan maturity periods were set at 40 years for the African Development Bank and 38 years for the World Bank, with a grace period of 10 and 5 years respectively, representing a concessionality rate of 60% for the former and 54% for the latter.

11 In 2005, the IMF and the World Bank established a joint Debt Sustainability Framework, which set out an analysis of country debt forecasts for the next 20 years and an assessment of the risk of a build-up of external debt over the same period, and issued recommendations for a borrowing strategy that would limit the risk of excess debt. Based on these, countries are classified in three categories: green countries with a low risk of excess debt, which are eligible for loans; amber countries with a moderate risk, which are therefore eligible for an even split of donations and loans; and red countries, which present a high risk and are therefore only eligible for donations.

the changes (except for Afghanistan and a few remaining low-income countries, mainly island states) and that maintaining a concessional financing window was no longer necessarily the most appropriate solution for addressing the new issues in the area. The African Development Bank is seeking to innovate by adopting unconventional measures, for example, its revised credit policy in May 2014.[12] The IMF reviewed the Debt Sustainability Framework in 2012 and is currently considering new amendments designed to include any type of concessional and non-concessional resources in its evaluations.

The difficulty consists of supporting overall consistency in policy terms, whilst at the same time requirements may be different. Achieving a coordinated approach can be even more complex where shareholder representation is dispersed within the institution and shareholders are likely to issue variable instructions. Whilst the German Ministry of Finance and the Bundesbank represent Germany as an Executive Director or Alternate at the World Bank and the IMF, for example, the Ministry of Cooperation has sole representation authority for regional development banks. China is represented by its Ministry of Finance at the World Bank and Asian Development Bank, but by its central bank at the African Development Bank and the Inter-American Development Bank. The same applies to several other countries. In addition, priorities necessarily vary depending on the supervisory authority concerned. The US, Japanese and French treasuries have sole supervisory authority over the IMF and multilateral development banks, whilst most traditional donors tend to be represented by their Ministry of Cooperation or Ministry of Foreign Affairs, which are generally less familiar with fiduciary issues. Government negotiators are keen to see better institutional coordination in relation to replenishment negotiations. In reality, coordination is only partial. There are countless working groups of experts from development banks on debt, evaluation, performance effectiveness, resource allocation, and so on. Coordination of this kind is useful but insufficient. The institutions alone, however, will not be able to make further progress in this area without encouragement or a clear mandate from their shareholders. The response to concerns about consistency therefore seems to be political rather than technical.

4. The multilateral development banks and the transformation of global economic governance

The 2000s were marked by a number of significant changes. Following the mistakes of the 1990s, the development agenda set itself ambitious goals, expressed in precise, quantitative commitments (the Millennium Development Goals) and a different way of organising and allocating aid (implemented through the Paris Declaration in 2005, the Accra Agenda for Action in 2008 and in Busan in 2011), moving away from the concept of aid effectiveness to focus on development effectiveness. Efforts to support development in this context, reiterated at the G8 Gleneagles Summit in 2005, resulted in additional efforts

12 The reform aims to make non-concessional resources accessible – under certain conditions – to low-income countries (ADF countries).

on budgets. Figures for official development assistance (ODA) calculated by the OECD showed a tripling of aid in nominal value between 2000 and 2013, to US$134.8 billion.

More significantly, however, other types of resources have shown exponential growth. Funds sent back to their home countries by migrants, for example, are three times higher than official aid (an estimated US$435 billion in 2014 according to the World Bank) and growth is set to continue; in the same vein, foreign direct investment has continued on an upward trend and commercial trade (imports and exports) has soared. Commercial trade between Africa and China, for example, was worth US$200 billion in 2013 compared with US$10 billion in 2000. Commercial trade between India and Africa increased by almost US$5 billion in 2000, and reached US$63 billion in 2012. It is also interesting to note the breakthrough of other emerging economies such as Turkey, where trade is now worth US$23 billion, with a target of US$100 billion by 2023. There is a clear underlying trend: on the one hand, the scarcity of concessional resources shows the necessity of being much more selective in allocating this kind of financing in terms of countries and sectors; on the other hand, it reveals the existence of significant non-ODA resources, which calls for the creation of new mechanisms to capture and generate value from them.

At the same time, new actors have emerged, such as philanthropists who have decided to devote part of their fortune to development (Chervalier and Zimet, 2006).

Nineteen philanthropists – mainly Americans – have each donated over US$1 billion of their fortunes, resulting in a total of US$77.5 billion. Bill Gates, in particular, stands out, with donations estimated at over US$28 billion, followed by George Soros (US$14.5 billion) and Warren Buffet (US$8 billion). The impact of some of their actions is indisputable. Without the Bill and Melinda Gates Foundation, millions of children would not have been vaccinated against polio and initiatives such as the Global Fund, Unitaid or Gavi may not have happened. The main changes to come, however, lie elsewhere.

The acceleration of globalisation is leading to an acceleration in large fortunes (Chervalier, 2008). The number of billionaires, for example, has soared since the 2009 financial crisis, with most new fortunes found in emerging powers; it is the advent of what *The Economist* called 'philanthrocapitalism' in 2006 (*Economist*, 2006). In 2014, the world had 2,325 billionaires, 965 more than in 2009. Their total fortune is valued at almost US$7.3 trillion. One sign of the paradigm shift is that African billionaire philanthropists now donate US$7 billion a year to the continent.[13]

Whilst globalisation generates numerous inequalities, it is also accompanied by a marked level of generosity. This was the motivation behind the initiative launched in 2010 by Bill Gates and Warren Buffet, the 'Giving Pledge campaign',[14] which includes a commitment to donate over half their fortunes to charitable causes.

13 Wealth-X and UBS Billionaire Census 2014.

14 By May 2014, 127 billionaires, or some 6% of the total, had signed up to the initiative.

The multilateral development banks have obviously seen the benefits they could derive from a financial windfall of this kind and have tried to capture them. It must be said, however, that initiatives are still very limited and targeted. Charitable organisations have stayed away from the financial replenishment processes of the three major development banks.[15] Only thematic funds or specialist institutions such as the Global Fund have benefited from substantial funding, alongside traditional donors.[16]

The new actors are also found in the emerging countries themselves. Overturning the global economic order that still prevailed at the very beginning of the twenty-first century, emerging countries are establishing themselves as powerful players and are increasingly open in their rejection of a system and world order in which they do not recognise themselves (Dervis and Özer, 2005).

Against this background, there is a growing temptation for emerging countries to create their own institutions or develop specific mechanisms distinct from the traditional windows.[17]

The initiative to create a 'New Development Bank', officially announced in the summer of 2014, marks the end of several years of discussion. It would be reasonable to take the view that the major emerging countries assessed their degree of power during the major financial crisis in 2008, which saw the G20 gain official recognition as the main focus of global economic governance. The situation is clear: economic growth is now linked to emerging countries and the current system has not taken sufficient account of the changes that have occurred. The United States retains its right to a veto within the Bretton Woods institutions and continues to host the head offices of the World Bank and the IMF, whilst the Europeans, whose representation is still dispersed within the various governing councils and boards of directors, continue to run the IMF. Emerging countries, however, have nothing, although the BRICS alone represent more than half of the world's wealth. Two separate institutions have been announced: the first, based on the model of the World Bank, will have funds of US$50 billion used to finance infrastructure projects; the second, called the 'Contingent Reserve Arrangement', will have initial capital of US$100 billion and aims to provide assistance to countries in financial distress. The amounts involved are modest in terms of having a real systemic impact, whilst the BRICS themselves have divergent interests. Moreover, other emerging countries that are more significant in terms of GDP than South Africa, for example, are excluded (Mexico, Korea, Indonesia and Turkey). The launch in Beijing, a few months later, of the Asian Infrastructure Investment Bank (AIIB) – whose majority shareholder is China and whose aim is to fund infrastructure projects in the region – has declared itself a direct competitor to the World Bank and the Asian Development Bank.

15 Only national governments have contributed to the concessional financing windows of the various replenishment cycles of the World Bank, African Development Bank and Asian Development Bank.

16 Only the Global Fund (whose last replenishment cycle, GF4, took place in 2013) has benefited from non-state funding, mainly from the Bill and Melinda Gates Foundation (Manning, 2014).

17 It was in this spirit that the African Development Bank signed an agreement with the People's Bank of China on 22 May 2014, on the creation of a joint fund of US$2 billion – the Africa Growing Together Fund.

The United States was right in its assessment and therefore shared its concerns officially. Three of the region's major economies (Australia, Indonesia and South Korea) were not present at the ceremony. These initiatives are sending an unambiguous political message to the existing institutions.

It has also become apparent that the emerging powers – whilst not divorcing themselves entirely from the multilateral development bank system – are maintaining a calculated distance.

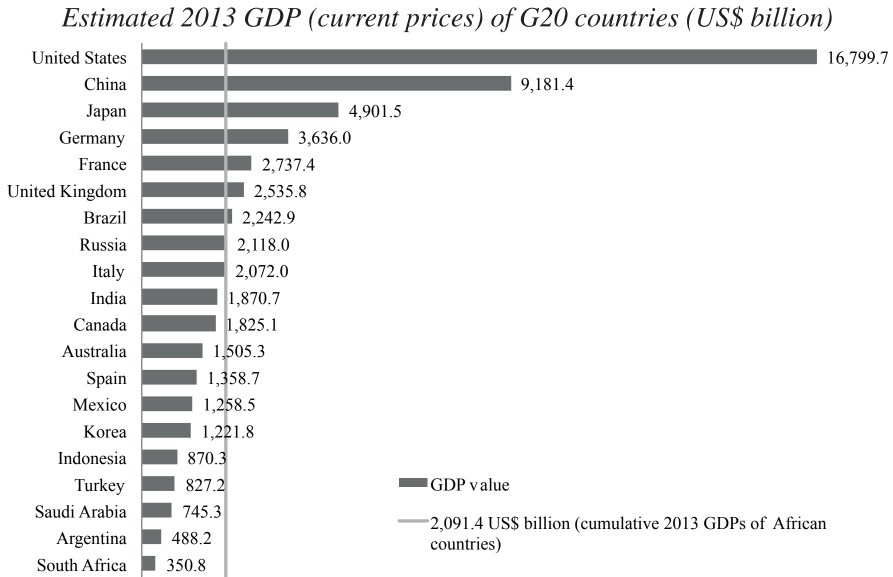
China, for example, has refused to make any significant top-up contributions to the Asian Development Fund on the basis of huge remaining inequalities and internal challenges. The dominant position of another traditional advanced economy, i.e. Japan (and the fact that the institution is run by a Japanese national), is obviously another reason. Although contributions from the emerging economies increased for the last two rounds of replenishment by the World Bank (IDA16 and IDA17) and the African Development Bank (ADF12 and ADF13), they are still marginal compared with contributions from traditional donors. A 92% proportion of contributions to ADF12 (some US$9 billion) came from North America, Europe and Japan. African countries, the Gulf States and all the emerging countries contributed just 8%. The traditional countries are urging the emerging powers to assume their responsibilities, whilst the emerging countries do not believe they have not been granted the place they deserve in the governance of the institutions.

This governance issue goes far beyond the issue of development only, and relates to the challenges of constructing a new form of global economic governance.

The main difficulty comes from the fact that the change in economic power relationships is not yet over and that the world is in a period of transition, or even instability, because of the speed at which change is occurring. Whilst China has become the world's second largest economic power and is set to outstrip the United States before the end of the next decade, it is also clear that the traditional economic powers are still strong and that the transition will take several years. By way of example, the GDP of the 54 African countries is still only equal to the GDP of Italy, or 70% of the GDP of France or the United Kingdom. As a result – and as with the tensions that surrounded the reform of IMF quotas in 2010 – the advanced economies are reluctant to pre-empt a change that is probable but still only partial.

Figure 6.1. *Emerging powers in evidence but not yet dominant*

Estimated 2013 GDP (current prices) of G20 countries (US$ billion)



Source: IMF World Economic Outlook Database, April 2014.

The reality of this situation, however, is masking the real challenges of the future, namely the values and political objectives of the future institutions. The current under-representation of the emerging economies in the governance of multilateral development banks provides a simple diplomatic weapon for highlighting the inadequacies of the current system and justifying a limited financial contribution to low-income countries; on the other hand, it allows the traditional economies to maintain their positions of power. The status quo is thus satisfactory, to an extent, on both sides. But it is obviously not sustainable in the long term.

It seems unlikely that the change will be incremental, insofar as the emerging economies want to distance themselves from the spirit of the Bretton Woods Agreements as well as their governance structures. Granting additional powers is therefore not an end in itself; it may even seem counter-productive for low-income countries, since they would not necessarily be accompanied by corresponding additional resources.

Conversely, once the emerging economies have political power in line with their economic power – although they do not constitute a homogeneous group – a power relationship will be established that will define the values and political objectives of the new multilateral development institutions.

There are therefore two possible scenarios in terms of preparing for the future. One is a ‘soft landing’ scenario, which would make it possible to manage the transition gradually and prepare for the post-2020 reforms in stages, in terms of voting rights and the location of the institutions’ head offices, the nationality of the directors, changes to the institutions’ terms of references, and financing

reforms for low-income countries, which would help define the outlines of a new multilateral framework. The other is a more brutal, 'hard landing' scenario, which would maintain the status quo for a few more years through a series of mini-reforms, but in which change would be implemented under duress, more forcibly and quickly, with the risk of a dual system. The creation of the new BRICS bank and the AIIB can be seen as a warning sign of this development.

Conclusion

The multilateral development banks have undergone numerous changes since their creation. The acceleration in economic change since the beginning of the twenty-first century, coupled with the creation of new, specialist institutions and the proliferation of trust funds means going a step further, to review the relationship between institutions, their respective mandates and their governance structures. The overlap between organisations and the resulting sophistication makes the system too complex to be understandable and efficient, and ultimately raises the question of its legitimacy.

At the same time, although extreme poverty is declining at a global level, it remains a challenge for many countries, particularly in sub-Saharan Africa. Whilst the middle classes are set to grow significantly over the next ten years – including in Africa – widening inequalities will be a major issue for the multilateral development banks. Against this background, there is still every reason to maintain a specific window targeted at the poorest countries.

Finally, simple technocratic responses will not be sufficient to tackle the challenges around consistency and governance faced by the multilateral development banks: overall political coordination is needed. To cite an African proverb: 'if you want to walk quickly, walk alone; if you want to walk far, walk with others'. In this spirit, a conference on the future of the multilateral development system under the Turkish presidency of the G20 in 2015 – an imperfect body, but the only one currently in a position to launch this type of initiative – would have the merit of starting a collective discussion to establish a roadmap for the 'post-2015 agenda', with the aim of redefining the division of labour between the various multilateral development banks and specialist funds and starting to work on overall governance over the period 2015-2025. In practical terms, sector-specific discussion groups (for infrastructure, climate and the environment, education and health) could be set up, based on the model of the G20 Infrastructure Working Group, to issue operational recommendations to the sherpas, with the aim of redefining the terms of intervention of the finance development institutions.

The launch of the US$10 billion replenishment cycle for the Green Climate Fund at the end of 2014, and the organisation of the 21st Climate Change Conference in Paris in December 2015, offer an initial opportunity for action to begin the reform of climate change financing. The issues are clear. All we need to do now is act.

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7

What Does the Future Hold for the Multilateral, Regional and National System of Development Banks? A Post-2015 Outlook

JEAN MICHEL DEBRAT AND MAMADOU LAMINE LOUM

The post-World War II incentive to build and restore peace through development resulted in the creation of the development bank; a concept that has over the past 60 years acquired a distinctive identity despite the many political, legal and operational differences that characterise its various incarnations. What's more, all these institutions specialising in development financing exist as a whole within the development financing community. The community's members are connected in various ways and organised according to specific schemas. The last 20 years have brought many geo-political changes, which in turn have lead to the creation and rise in prominence of new private and public financial institutions. The future of these institutions is now open to debate.

The purpose of this chapter is to offer a forward-looking vision by shedding light on the whys and wherefores of these changes. Both authors – one from a developed and the other from a developing country – have long operational careers behind them. They asked the same questions and came to common conclusions that serve to inform the debate.

1. SIGNIFICANT INSTITUTIONAL DIVERSITY WITHIN THE DEVELOPMENT BANKING SYSTEM

1.1. What is a development bank?

At the very root of the idea of the development bank lies the political will to allocate financial means to general, long-term objectives in highly specific historical contexts, such as the post-World War II reconstruction of Europe; the laying of foundations for industrialised economies in non-industrialised countries; the progressive integration of various EU member states; the reunification of Germany; the allocation of oil resources to the development of Muslim countries and communities; the laying of foundations for economic development in Africa by means of modernisation, sector diversification, and the introduction of national economic operators both inside and outside national borders; as well as transitions from socialist to market economies.

In each of these cases, the long-term investment rationale is applied to widely different geographical areas and levels of development. Therefore, every individual institution has its own distinct identity, which informs its corporate culture.

The first criterion defining a development bank's identity is that of the capital composition/intervention area pairing. This is the best indicator of the political will leading to the creation of a development bank. The capital is always composed of public funds provided by sovereign states, while geographical considerations typically determine the area of intervention.

The second criterion pertains to the origin of financial resources, and more particularly to the volume of free resources provided by founding sovereign states: subscribed and called capital, resources used as subsidies reassigned to beneficiaries or mixed to form subsidised financial products. The origin and volumes of these public resources give institutions their 'profiles'. Furthermore, these are all hybrid financial institutions, as they borrow resources from financial markets, which they then reassign.

Finally, when it comes to defining and creating a development bank's identity, its headquarters play an extremely important role – they create a link between the institution and its host country.

These specialised financial institutions make up a development banking 'community'.

1.2. Great institutional diversity structured by the origin of resources and the organisations' cultural orientation

By virtue of their status, only the World Bank and the International Fund for Agricultural Development (IFAD) may be deemed 'global'. In its own way, The Islamic Development Bank also has a worldwide mission.

The International Fund for Agricultural Development

The IFAD's field of operation covers rural and agricultural sectors across the globe. It became a specialised financial institution in 1997 following a series of food shortage crises in the 1970s. To finance its operations, it relies on an OPEC/OECD partnership.

The World Bank

The World Bank has some fundamental characteristics that limit the extent to which it can claim to be a 'common financial institution' to be used 'equally' by all mankind. These characteristics are well known:

- The composition of capital determines the balance of power on the board of Ddirectors. As a result, it is the World War II-winning industrialised countries that have the most influence – with the United States at the top of the ladder and the only country with the power to veto decisions. The use of this power is a fundamental attribution of the US Treasury.
- The considerable free funds available to the Bank are of two kinds: (i) resources from the International Development Association (IDA) (that

includes 172 members), which come from 31 donor countries (category 1 list); and (ii) Trust Funds, which are the result of individual initiatives from certain states (including Japan and many European countries) who entrust their management to the bank according to its own rules.

- The use (unlike in the UN) of a single language, English, and the Bank's headquarters in Washington, where everything happens and is decided, finally gave the Bank a profound cultural mark. Furthermore, a very large proportion of the staff, although from all over the world and making the Bank one of the world's most diverse social backgrounds, also underwent training and obtained qualifications from US universities.

These fundamental traits explain the continuing ambiguity of the Bank's image, as it is by nature a 'global public resource' and yet rarely perceived as neutral and equidistant.

The Islamic Development Bank

Early on (between 1973 and 1975), the Islamic Development Bank constituted an important innovation: composed of members of the Islamic Conference, its scope of work is not geographic, but concerns the countries with consistent Muslim communities. Its procurement rules are compatible with Shari'ah, and its governance and financial operations are comparable to those of a development bank. In terms of its capital, Saudi Arabia alone accounts for 23.6%, the top nine shareholders constitute more than 80%, while the subscribed capital for all the other countries represents less than 1% per country. The rules of proportional voting on capital holdings thus create a power structure in which more than 40 countries are, in practice, simple beneficiaries without the ability to wield influence.

1.3. Regional banks

Regional banks are also multilateral. As with the IDA, there is a distinction in the capital of regional banks between non-regional members in the position of non-recipient funders, and regional members who represent the geographical scope of action. However, the share of non-regional and non-borrower shareholders is a minority, which obviously bears on the decisions of the board of directors. Similarly, regional shareholders dominate if their staff can be recruited on a broad geographical basis.

The fundamental role of regional banks is to:

- attract resources from states demonstrating a specific interest for the region; and
- have an investigation and decision-making process much closer to the political and social realities of the states of the region.

Note that the AfDB further enhances this adaptation to local realities by taking a stake in seven 'sub-regional' African development banks.

This greater cultural proximity does not, however, exclude complex role-playing between stakeholders that goes beyond the spirit of cooperation and falls under competition for influence.

1.4. National development banks

'National development banks' are a diverse group, but their common feature is to have a capital contribution from a single sovereign state, for which the bank is one of its financial instruments. However, a distinction must be drawn between national banks operating in their own country and 'bilateral' national banks intervening abroad.

National banks

National banks finance their country's development by mobilising local resources complemented by foreign resources. Their activity and its evolution are inscribed in national histories. In Africa, they emerged from the needs associated with the foundations laid for a modern economy in its infancy. Their mission was then to initiate development financing at a time when global savings (both public and private) were high and enterprise skills low; to facilitate and develop the essential social and economic transformation; to structure activities, industries and fields; enhance inter-sectoral links; and to encourage the transfer of foreign assets or national operators.

Development banks have emerged in all countries without exception, acting with the assistance of international cooperation. During the first two decades after independence, they played a leading role in crisis and emergency management. Misgovernance and mismangement abuses culminated in the third decade, following huge macroeconomic disturbances that would subsequently be at the root of acute financial crises. These crises affected primary banks and central banks, and development banks did not escape unscathed; most were liquidated or restructured, for the benefit of private capital, as part of a comprehensive reform covering the following aspects:

- liberalisation of credit policy guidelines;
- promotion of indirect monetary management instruments;
- criteria for the standardisation and evaluation of credit;
- independence of granting and withdrawal of bank accreditation structures; and
- periodic monitoring of operations and results of credit institutions, among others.

The financial costs of reforms and restructuring were borne by the member states and repaid over the long term; the owners were paid proportionally to the recovery of non-performing loans. To top it off, conditions for financial partners accompanying the process limited the member states' stake in bank capital to a maximum of 25%.

At the end of this period, the universal bank played a leading role in the new environment, while many domestic economic operators found themselves orphaned by the ‘deceased’ development banks.

Bilateral development banks

KfW

KfW, which originally managed US funds for the reconstruction of Germany, is today a premier issuer on financial markets. KfW widened its activities to financing development in Africa, Europe, and eventually worldwide. It received large subsidies from the German government and implemented a cooperation policy defined by the German Ministry of Cooperation (BMZ). It remains the most important financial institution in Germany, and its international activities only represent 5% of its business.

DBSA

The chief mission of South African development bank DBSA, whose capital is provided by the South African treasury, is to finance municipalities and national policies for education, health, housing, employment, or the green economy. But its mission is also to finance regional infrastructures in the South African Development Community (SADC), especially these playing an integrating role for the regional economy.

The development banks of France, Japan and Kuwait are purely national, but dedicated to external financing:

AFD

The prime mission of AFD, a French public institution headquartered in Paris with a French operational staff, is to finance development in 70 foreign countries, half of which are located in Africa. AFD is both a bank raising its funds on international markets and relending to public or private entities as well as a government agency that implements the guidelines of the French government. Like all other development banks, it is also subsidised by the (French) government.

JICA

Japan has a cooperation agency, JICA, that implements the Japanese cooperation policy. Half of its business consists of donations, while the other half consists of loans benefitting 64 countries, the majority of which are in Asia.

The Kuwait Development Fund

Following the same initial model as the Saudi Development Fund, the Kuwait Development Fund, created in 1961 by a Kuwait law, is a full-service financial institution. Like other development banks, it is empowered to grant loans and guarantees, provide subsidies and finance technical assistance. Initially

dedicated to the development of Arab countries only, FKP has been open to all developing countries since 1974. As one of the tools of Kuwaiti diplomacy, its capital increased steadily to account for its growing activity in ever-wider geographic areas on all continents.

All these bilateral agencies form a family insofar as they share a key characteristic: their action is based on financing contracts which are bilateral in essence and reflect a cooperation that is both technical and political. Their long experience and considerable flexibility make these institutions centres of expertise and innovation. Beyond their bilateral nature, they are primarily highly specialised institutions. Nineteen of them meet at the International Development Finance Club (IDFC), an association that discusses their common types of sectoral interventions and whose largest players are JICA, KfW, AFD, BNDES and CAF, among others.

1.5. The case of European multinational development banks is also specific

The European Investment Bank (EIB)

The EIB is an institution of the European Union created to finance the development of various member states in order to ensure harmonisation of EU territory. The successive enlargements of the EU have significantly strengthened this mission, including for the pre-accession countries. Yet, from the start, managing interventions in Africa and in the ACP, in Mediterranean countries, in Asia and in Latin America represented a minor but significant activity. This demonstrates that, if it were needed, the development mission identity is more tied to territorial construction than to a given level of development.

The European Bank for Reconstruction and Development

The case of the EBRD is different: it is an international organisation based on an establishment agreement. Its capital is owned by 63 countries – European, for the most part – held together by a financing mission to transition socialist economies into market economies. It should be noted, however, that today the EBRD operates beyond its original mission following a territorial logic in the Mediterranean, in the context of competition, rather than cooperation, with other European development banks.

1.6. International trade financing institutions

Finally, let us emphasise the role of a little-known category of domestic financial institutions: those that are exclusively dedicated to financing the private sector. To date, 15 European DFIs have financed more than 3,800 companies to the tune of some €28 billion. Furthermore, many development investments are not financed by development banks in the conventional sense, but by financial institutions whose purpose is to support providers in their country – the Overseas Private Investment Corporation (OPIC) in the US and the Japan Bank for International Cooperation (JBIC) are powerful development tools. Later on in this chapter, we

will examine the cases of development banks in emerging countries that practice such cooperation, and of development banks in future and aspiring emerging countries.

2. The functioning of the system of development banks generally meets their mission but also has weaknesses

2.1. The financing capacity of development banks

The overall financing capacity of development banks is by far the most important question. The equity of each development bank is high because of the macroeconomic and political risks it takes, and because of the need for ratings that allow issuances on the best terms that international markets can offer.

Although the equity of all these financial institutions has been regularly raised, the overall supply of funding remains well below actual needs. Three major political implications arise:

- Among all the criteria that lead to decisions on the financing of a programme or infrastructure, the financial decision is essential, giving considerable power to development banks, a power which is de facto political.
- The poorest countries with scarce local resources and limited access to international markets are placed in a position of dependency, even when they are shareholders of a multilateral institution, by status.
- The role of shareholder countries is proportional to their contributions. Unlike national banks with a clear political dimension, the decisions of multilateral banks always reflect complex – yet not necessarily transparent – negotiations within the boards of directors with representatives from the finance ministries of shareholder countries.

2.2. Co-financing by development banks

Co-financing by development banks is a direct result of insufficient supply, and of the banks' desire to limit the size of their unit risks (by country, project or borrower).

Yet, this is at the very heart of the relationship between development banks. The identification, examination, and design of financing agreements, and the distribution of contributions from each institution, are subject to longer negotiations between donors than with the borrowing countries. Banks each have their own mandate and their own set of internal rules that can differ significantly, not to mention the fact that, more often than not, borrowers must also negotiate parallel and complementary funding. In line with the Paris Declaration, this situation also gives rise to multiple attempts at coordination that prove to be power struggles within the 'community' of donors.

2.3. Codification

Theorising and 'establishing rules' are extremely prevalent in development financing. All development banks, whose boards (independently) approve large

numbers of concept papers and academic writing, share this trait. In reality, banks seek to exercise a 'soft power' directly linked to the political will of their shareholders.

The World Bank is by far the largest and most influential producer of codification because of its size, the importance of the trust funds at its disposal to finance studies, and its close relationship with the top US universities. The World Bank provides an essential and dominating contribution to the 'science of development'. However, the drafting of guidance documents and rule-making reflect intense internal intellectual debates and bear the mark of the considerable external lobbying the Bank is subjected to. These are wide debates, but they cannot be considered universal. Once approved by the Bank's board of directors, the internal rules and guidelines are binding on borrowers as well as on co-financiers, with no room for discussion. Given the importance of its financial contributions to projects and programmes, the Bank ends up playing a dominant role, which raises the question of political legitimacy. The issue is not with how open the discussions are; for instance, the ongoing review of the Bank's environmental and social policies – notably to protect vulnerable populations, human rights and the environment – is the subject of heated consultations. The problem stems instead from the fact that such debates are in reality only open to organisations and countries that have or give themselves the means to participate. During the appraisal of projects, World Bank internal rules may therefore be opposed to recipient countries who are not familiar with them. All that is left for them is to 'negotiate'. But the bargaining power obviously varies for each borrower, whether it is China, Vietnam, Nigeria or a small LDC.

2.4. Community of donors

What is true for the World Bank is also true for most institutions. It is also useful to wonder about the functioning of the 'community of donors'. This term is somewhat strange because it defines a group that excludes borrowing countries, which the 'community' has trouble naming; they can be referred to as 'borrowers', 'recipients' or 'partners' (to be politically correct), but never as 'customers' or 'contractual partners'. This hesitation over semantics highlights an existing hindrance, as does the expression 'technical and financial partners' used to refer to banks.

The general meetings of those multilateral banks whose shareholders consist of the greatest number of public development stakeholders offer regular opportunities for the coordination of donors. As a consequence of these meetings, it is often decided to establish letters of exchange or of framework agreements.

All development banks have services dedicated to international relations between banks, with the goal of harmonisation. In fact, genuine harmonisation occurs at the policy level: the development banks have a set of 'visions', 'missions', 'objectives', 'priorities' and 'operational principles', most of which are similar. But institutions each adopt their own variation on the set, which will also evolve over time. The chief virtue of discussions is to create consensus, but they are far from trivial in the context of the financing shortage as described

above; for instance, the priorities for the financing of agriculture vary a great deal.

2.5. Structuring forms of coordination

Interbank relationships are sometimes organic: the IDB, the Kuwait Fund, and the AfDB have an equity interest in regional financial institutions. On another note, European 'facilities' enable the EU to strengthen and coordinate co-financing operated by other European financial institutions. There are also many bridging mechanisms. Delegations of credit allow development banks to refinance projects in other institutions. For example, the six credit lines of the AFD and DBSA helped reinforce the funding of South African local authorities, while making full use of the expertise and local knowledge of the DBSA.

Similarly, guarantee and counter-guarantee mechanisms are useful for the joint definition of financing offers.

These tools play multiple roles: donor states without bilateral agencies can delegate their funds to multilateral or national banks. Also, the member states of a regional bank can entrust funds in return for the bank's expertise.

These collaboration mechanisms face significant limitations: financing contracts respect the standards adopted by various boards of directors, and are therefore numerous for a single project. Above all, these contracts provide conditions for implementation that meet the internal standards of each institution. This is the most difficult part of the relationship between development banks and their borrowers. Conditionalities contained in the contracts can affect the very design of projects, the financial enforcement mechanisms, contracting, and all social and environmental dimensions, all of which are subjects of high political sensitivity. When they have a choice of donors, borrowers can consider this constraint, but this is obviously not the case for the poorest countries.

After this very brief overview of the types of relationships between development banks, it is once more clear that a political analysis of these relationships is crucial. At this point, it is important to consider the perceptions of borrowers.

2.6. The opinion of borrowers matters!

Many infrastructures and private investments have been funded by development banks and many state policies have been implemented. It is therefore crucial for funders to demonstrate and adequately evaluate the impacts of their funding decisions. Nevertheless, the results are not the same across countries and geographical realities, and one cannot measure the efficacy of funding based on a country's overall development, since the level of funding is much lower than is needed. There is no consensus on appropriate evaluation methods, which creates confusion in the debate and also negative perceptions. It has even been said that 'development banks are a necessary evil'!

This analysis brings to light several issues:

- First, decision-makers in developing countries do not recognise their social, economical and geographical identities in the mode of action of the development banks. The informal sector comprises everything funders are unable to fund and, in some regions, can amount to 80%

of the population's activity. Acknowledging the economics of the poor and the utility of a social economy is the aim of a school of thought that looks at possible theoretical grounds for new funding strategies. For instance, in rural projects it is crucial to change the farming societies.

- A second major issue stems from the rise of the development banks' role as 'substitutes for strategic decisions', whereby they take it upon themselves to define aspects of a country's activity that should be decided by local authorities. The prime example of this is the conception, drafting and elaboration of a country's 'strategic document' by development banks and by external consultants. These documents become formally applicable in the relevant countries, and if they are later regarded as internationally binding commitments, such a substitution becomes incompatible with the countries' constitutional mechanisms and does not give national parliaments any say.
- The latter issue also applies to the selection of projects and funding priorities. Strikingly, when some developing countries attempted to define their own project pipelines, they could not impose them and their 'decisions' became merely 'intentions'. Indeed, the New Partnership for Africa's Development (NEPAD) itself almost suffered from this phenomenon. The development banks remain the de facto sole deciders of which projects are funded and which are not, a situation that the developing countries can hardly accept. It is not solely a matter of power balance, but also the result of the development banks' broad range of competences. There is also a question of principle: where do we place the bar for the acceptability of a breakeven point/timeframe ratio (a key element to fund a project)? If the current level of acceptability had been implemented in Europe in the nineteenth century, few of the large infrastructure projects of the time would have been funded.
- The banks have to adapt their orientations and doctrines to local historical, social and political factors. The consensus is that such adaptation has been insufficient, in particular when the doctrinal rigidity has little to do with the country that needs funding – the classic example being the US finance bills that apply to US executive directors in multinational banks. In a recent case, one director quoted the 'prohibition of hydroelectric dams', of which China has become a much solicited leader in construction.
- Procurements are another crucial point. Each bank aims at funding projects efficiently, impartially and without corruption. These rules form part of the administrative culture of the Western developed countries; developing countries do not regard their uptake as a 'condition' of development.

In conclusion, despite many efforts by those within the sector to organise themselves, flaws remain in the development banking system: it does not meet the needs, the 'science' of development is not regarded as universal, and

countries defend their right to decide which investment is chosen and to monitor implementation.

In a globalised world, such a situation is bound to change.

3. The playing field for development banks is fundamentally different in a globalised world

3.1. The leading role of national development banks in important emerging countries

The emerging countries achieve their development with their own politics and, for the most part, their own resources. National development banks form part of these resources, so their range of actions corresponds to the internal market. The China Development Bank (CDB) and the Brazilian Development Bank (BNDES) are now, in terms of size, the two main development banks in the world. The balance sheet of the BNDES exceeds US$370 billion and its annual spending is three times that of the World Bank. The BNDES works with concessional financing, including US$10 billion of subsidies from the Brazilian government. Moreover, it has started promoting the international branching of Brazilian companies into countries where local projects include importation from Brazil, thus increasing the country's international power. This is a kind of tied aid, similar to that which older bilateral development banks produced for a long time. To develop, Brazil needs its development bank to go global.

The CDB is a financial operator that serves the Chinese government and Chinese companies abroad. Its main characteristics are the following:

- Perfect integration into Chinese foreign policy – at the 2012 FOCAC in Beijing, the Chinese prime minister himself announced that global credit (concessional or otherwise) to Africa would amount to US$20 billion over three years.
- Vertical integration with the network of Chinese operators, from equipment providers to the companies that implement the project or provide technical assistance. Chinese aid comes in packages and is tied.
- An absence of functional integration with other funders: partner countries can choose to attribute 90-100% of a project to China or to go through other development banks that will impose open, international calls for tender (in which Chinese companies can bid). China is pragmatic – in Africa, it decided to invest in countries that other funders would not support (Sudan or Zimbabwe, for example, due to political issues), in countries which rely heavily on China as a main buyer of commodities (e.g. Zambia), or in countries where Chinese manufacturing companies are present (e.g. Ethiopia). Furthermore, China accepted to fund projects that traditional development banks had refused: 80% of the dams built in Africa over the past ten years were funded and produced by China. China's financial cooperation has become an aspect of the country's

global economic and political cooperation, and constitutes a welcome increase in the overall funding offer.

- Striking legal and financial opacity of the CBD's signed contracts, particularly when reimbursements take the form of commodity delivery; this prevents any comparison with classic contracts.

3.2. The rise of middle emerging countries' financial institutions

Smaller emerging countries, such as Korea and Turkey, have followed the same path, with their national development banks working abroad to sustain their own national growth and foreign markets.

In South Africa, the DBSA intends to play a similar role. It was founded as a 'regional' bank for the state and the 'homelands' during apartheid, and became an institution for the SADC after the end of the division in 1994. However, the institution suffers from a lack of subsidies from the South African National Treasury and from poor financial quality of its resources. It is therefore looking for free resources in China, among the BRICS or in the European Union.

3.3. Towards a new multilateral institution?

The BRICS summits now represent an opportunity to promote a multilateral development bank that would be based not on geographical, cultural or religious visions, but on supposedly common geopolitical interests. Such circumstances are not so different from those that of prior multilateral banks. This project is moving steadily forward and could become a reality. It is supported by a strong rationale:

- to bridge the global funding gap – in Africa, the BRICS Bank is expected to complement the AfDB, which cannot fully provide for the needs of the continent;
- to give each funder an influence proportional to its investment in the capital;
- to promote the academic influence of Shanghai, where the headquarters would be located; and
- to promote the commercial interests of the member countries' operators.

Unsurprisingly, the structural choices that have led to the construction of the development bank system over the past 60 years will this time benefit the emerging countries.

The BRICS Bank project also seems to answer the criticisms of the current system: the aim is to select projects based on criteria closer to the political will of the states, to free oneself from the procurements of other development banks, and to escape the rules of these banks. However, one may ask how issues such as the management of social and environmental impacts will be handled by the new multilateral bank, or even of tying funding to the sole members of the bank.

3.4. New global mechanisms

Globalisation not only changes power relations, but also the funding needs relating to global issues (climate, health, education, access to water or electricity, and so on). The UN conferences, a strong marker of globalisation, have yielded several 'commitments' such as the Rio discussions or the MDGs. Globalisation has created new financial mechanisms.

Since 2007, there has been debate over how the funding architecture can be modified to tackle climate change.

- At the Bali Climate Change Conference in December 2007, the principle of financial transfers from industrialised countries was adopted, but ongoing discussions concern the volumes of these transfers and their integration or otherwise into previously agreed development funding.
- The legal and institutional form of new institutions, and their mode of governance, are under discussion – should we follow the UN principles or those of the World Bank?
- How should projects be examined and evaluated, particularly with regard to expected results, impact measurement, and so on.

All of the above are key to the future of the development bank system, in so far as funding for climate change forms part of the wider issue of global development funding. It is about funding for the production of power, for transportation infrastructure, for urban planning, for housing conditions or for other needs? Should we create a specialised institution or a special global interest subsidy fund? What should the rules of funding be for such a fund? Who should manage it and according to which governance model? All of these are questions for any development bank to address.

It should be noted that at the Copenhagen Conference in 2009, the Stockholm Environment Institute emphasised that, besides internal funding in emerging countries, the largest four bilateral development banks invested €8 billion in climate-related projects, while the main four multilateral banks invested €4 billion (Atteridge *et al*., 2009). The funding architecture for climate is a key issue and much competition occurs between the various actors. Indeed, each organisation promotes arguments that serve its own institution's interests. The World Bank first promoted the idea that the Green Fund should fund public policies or chosen projects through central governments. Bilateral banks that form the IDFC – which fund local governments (city-based GHG emissions amount to 40% of total emissions) and private and public companies (that work in the fields of energy, transport, industry, etc.) – prefer to promote a Green Fund that would benefit financial structures with direct climate impacts for the local and economic actors, because such financial structures can and must be complemented by funds from commercial banks. These bilateral banks could then offer financial structures with a subsidy rate that corresponds exactly to the profitability of the project, according to the field or the local context. In combination with the development banks, the Green Fund would act as a lever.

Finally, everyone agrees that the funds can be sovereign or not. However, no accreditation procedure has yet been approved to decide which institutions are eligible for the Green Fund. The general interest rationale would favour a wider participation, but competitive interests appear to remain strong.

Will the profound changes of the coming years follow the usual mechanisms of geopolitical power relations in a globalised context, or will we seize the opportunity to reinvent the funding of development?

4. Post-2015 prospective discussion

4.1. The main issues

- The development banks represent only 10% of the investment and public policy funds in the developing countries. Is it politically feasible to increase this proportion, or is it more realistic to consider this 10% as a catalyser by associating the funds in a functional way to the other means of market funding?
- Will the development banks manage to fund the ‘informal sector’ by funding the micro-private and social economy sectors?
- The development bank model remains powerful thanks to the knowhow in research, strategy definition, project analysis and follow-up, impact evaluation and analysis, and so on. However, there are issues of shared power with their partners. This uneasy relationship is no small detail, and the evolution of the system will depend on whether or not it has been tackled. The statutory differences between ‘bilateral’ and ‘multilateral’ relations are not the way to deal with this difficulty.

4.2. Two opposing evolutions can be foreseen

- The rules remain the same, but the actors and the power relations differ. Competition between actors will generate negative dumping phenomena in terms of tied aid, local content and transparency, while each institution remains a geopolitical actor for its shareholders, guarantors and providers of ‘free’ resources.
- The financial institutions place their territorial partners at the centre both at the level of strategy, production and academic exchanges, and at the level of programme definition and funding. Contracts would be negotiated at the level of wider regions, sovereign states and local authorities, providing the various financial institutions with an active collaboration scheme. This idea is not new; its fundamental principles can already be perceived in the Paris Declaration, the Accra Agenda and the Busan Partnership, or in the ‘ownership’ principle defended by the World Bank.

The issue is now about acting rather than declaring. It is about continuing with or ending double speak: the Zhou Enlai principles versus practice (the ‘driver’s seat’ or power relation), agreements between funders versus fighting

for market places, global objectives versus decision-making based on 'weighted shareholding', long-term objectives versus medium-term levels of profitability, and so on. The second scenario will never become a reality if is it not supported by a wider political debate.

4.3. Concrete actions can be discussed to promote the second solution

- A wider debate about the overall equity level of the development institutions, because this level is a primary condition of the system's funding capacity and security. This debate will be a competition in which each individual state must know clearly what its national interest is. This is true for both national development banks and for international banks, for which the shareholders must decide on their own expected weight.
- A debate to discuss the interaction between the global funds and the system of the development banks, as well as the possibility of joint funding with commercial banks. This is a political, ethical and technical debate. The development banks cannot remain a separate type of global funding (it is a niche). On a short-term basis, the implementation of the Green Fund could provide the occasion for this debate.
- Would an umbrella organisation be necessary? Its primary function would be to coordinate financial institutions involved in given projects, and the IFAD already does this when it promotes rural mechanisms for inclusive transformation worldwide. In its post-2015 agenda, the IFAD explicitly offers to take up such a function.
- For study funds, a general management principle: at least 50% of such funds should be given to universities and research entities in the concerned countries.
- A truly collaborative methodology to identify and fund programmes. The European Union has developed a noteworthy collaboration in South Africa (IIPSA) whereby the EU provided the South African central government with an Interest Subsidy Fund that the DBSA (the national development bank) manages. Decisions to fund projects are taken by a steering committee chaired by the South African Treasury, while the EU is present as an 'observer' and has a veto. The funding proposals are presented by the DBSA after discussion with the development banks that support this mechanism and which are invited to declare their interest in the projects during the appraisal phase. With this mechanism, South Africa remains the primary political authority and the possibilities and technical expertise of the development banks are fully taken advantage of.
- The above example shows the functional importance of national development banks. National development banks are increasing being requested by countries, not because of general demands but because these countries remain outside the global markets or because

international banks do not provide sufficiently adapted offers for their informal-sector-dominated economies.

In the least developed countries, the national development banks – or rather their essential functions – have been key to the initial promotion of development and of economic modernisation. They allowed for a first improvement of agriculture, a temporary import-substitution industrialisation, and the insertion of the national economy into the global trading networks for the importation of goods and the exportation of commodities or, more rarely, semi-finished products.

However, the national banks did not achieve a structural transformation of the national economy. Could they have done so on their own, without stable and substantial central government policies?

What will be the function of these banks in the post-2015 development agenda? In addition to the deficiencies mentioned above, we must consider other factors:

- At a systemic level, the national development banks in the least developed countries have only formed a part of a system that should have been centred on them and aimed at them.
- The strategic actors must be reviewed and the needs must be re-evaluated, with three dimensions being taken into account:
  - Public funding is no longer sufficient, but what should be the role of private capital in the equity of local development funding agencies?
  - Development strategies are focused on clusters and local concentrations; hence, shouldn't we include local governments alongside central governments in the new methodology of development banks? Research is fundamental for development, and we should therefore involve universities as centres for knowledge capital on development funding.
- Finally, the legal framework of action for development banks should be reflected upon to restore the equilibrium between lenders and borrowers in the negotiation of funding contracts and in the procurements that apply to projects. The current conflict-like management of these questions cannot continue; no contract can be successfully implemented without a true agreement. This is more important still than the funding concessionary fees. Conformity to internationally recognised good practices for contracts, conditionalities and procurements should become a criterion for elegibility for public development aid.

Conclusion

The community of development banks appears to be a globally, regionally and sub-regionally coordinated ensemble with many shared views on the available instruments, even though the political and sovereign dimensions of development can be seen as a barrier to the legitimate search for coordination that any system pursues in its organisation and mechanisms.

Over the past 60 years, the community has shown its relevance and has grown, with the creation of new institutions every time the following conditions were met:

- the availability of a sovereign funding capacity;
- the geopolitical will to act on a macroeconomical situation; and
- the occurrence of an issue that needed to be solved and that created both a need and a supposed absorption capacity.

The community will evolve further as globalisation brings benefits to the emerging countries and offers the possibility of change. China has its role, as do other emerging countries and the BRICS Bank project.

This evolution will give a role to all actors if it manages to respond to the needs of truly inclusive development and to the environmental challenges.

A real evolution of the methodology is necessary to give developing countries a chance. Will there be a true dialogue between the development institutions and their borrowers to produce balanced contracts that respect the sovereignty of states, or will the fields of intervention remain fields of competition?

This is an enduring question that will not be solved unless global awareness increases and a general move by the borrowers occurs. The borrowers have full legitimacy to act.

In the least developed countries, local actors have been too weak. They must be strengthened through improved capacity, implementation and evaluation possibilities and through reforms in the support of sectors that remain informal and for which the actors have different identities and knowhow. Their role, needs and objectives must be at the centre of decision-making, rather than the needs and objectives of the financial institutions at larger geographical levels.

Only then will we have contributed to building a system in which the actors are complementary and where the proposed products are better suited to the specific needs of the actors and countries. Developing countries have to organise all the necessary consultations to develop their own development policies. They also have to achieve an enhanced discipline and stringency. This is absolutely necessary if the 'community of funders' is to provide support that is truly tailored to national development priorities.

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8

Why We Urgently Need Clarity on the Post-2015 Development Agenda and Financing for Development[1]

Barry Herman

1. The negotiating challenge facing UN member states

To some extent, the UN's member states are guilty of the charge that when a substantive agreement cannot be reached, a committee is formed. The 2012 United Nations Conference on Sustainable Development (Rio+20) fell into this pattern (see A/CONF.216/16).[2] It created two committees that completed their work by September 2014 and returned the matter to the General Assembly for resumed consideration. That is, after the two committees presented their reports to the General Assembly in September 2014, the Assembly agreed to begin to negotiate the 'post-2015 development agenda', which is to be adopted at a meeting at heads of state level in September 2015 (as per resolution 68/6). They will face some difficult decisions owing to the different approaches of the two committees and the Assembly's further decision to organise an additional negotiation forum to work more or less in parallel with the Assembly's post-2015 effort – namely, the Third International Conference on Financing for Development (resolution 68/204).

2. Open Working Group on Sustainable Development Goals

One committee that Rio+20 created was the Open Working Group (OWG) of the General Assembly. Its purpose was to devise a set of Sustainable Development Goals (SDGs), which it proposed to the Assembly in September 2014 for

1 Originally prepared as an FES Perspective (Friedrich-Ebert-Stiftung, New York, August 2014). Used with permission.

2 Rio+20 also asked the General Assembly to create a more credible process for follow-up discussions to Rio+20 than the failed Commission on Sustainable Development (CSD), which had been created following the original Rio conference in 1992. The outcome of those deliberations is the High-level Political Forum on Sustainable Development (resolution 67/290), which will meet in the General Assembly every four years and annually in the Economic and Social Council and will 'spearhead the implementation and review' of the SDGs (see below). While aiming at high-level participation, the duration of its annual meeting and its Secretariat support seems organised much like that of the CSD, as per the 'Key Messages' of the Expert Group Meeting on the role of the High-level Political Forum, New York, 30 April–1 May 2014, available at http://sustainabledevelopment.un.org/content/documents/3750keymessagesegm.pdf (last accessed 11 May 2014).

adoption. The General Assembly had agreed in September 2013 to work 'towards a single set of goals, universal in nature and applicable to all countries, while taking account of differing national circumstances and respecting national policies and priorities' (resolution 68/6, para. 19). While it can be assumed that developed countries will be able to attain the SDGs on their own, various forms of international cooperation will be required to assist developing countries in reaching the SDGs while also realising their national development priorities. The post-2015 'global partnership for development', which the General Assembly will start to negotiate in early 2015, would thus include – but not necessarily limit itself to – international cooperation policies aiming to assist the developing countries to attain the SDGs.

At its session of 5–9 May 2014, the Working Group had a first reading of a proposal to adopt 16 'focus areas' of SDGs – they were not yet willing to call them 'goals'. Each focus area included a set of targets, most of which were aspirational – and hopefully also inspirational – embodiments of social, economic, and environmental imperatives of 'sustainable' development. However, one focus area – number 15 – was called 'Means of implementation/Global partnership for development'. It contained a list of 22 targets for international economic cooperation. Key areas included: market access for exports of developing countries; enhancing the means for technology transfer to developing countries; improving flows of official assistance and private financial resources to developing countries, while ensuring their debt sustainability; and strengthening the technical capacities of developing countries in various domains, while also promoting SDG-related partnerships among public and private stakeholders and monitoring overall progress in advancing towards realisation of the SDGs.[3]

Based on the discussion at that meeting, the OWG co-chairs proposed a set of goals and targets on 2 June. The international cooperation goal, now number 17, grew apace. Its name was lengthened to 'Strengthen and enhance the means of implementation and global partnership for sustainable development', and it contained 46 separate targets instead of 22. The targets were no longer clustered by type of cooperation (trade, aid, etc.), but as means of implementation for each of the preceding 16 other goals. Some of the targets were fairly anodyne. For instance, to help attain the proposed goal 'Achieve peaceful and inclusive societies, rule of law, effective and capable institutions', target 17.42 said that 'all countries should continue to act within the provisions of existing relevant international agreements'.[4] Other targets were more focused, albeit mostly embodying promises that had already been made previously, frequently with operative phrases such as 'realise timely implementation', 'implement [an existing commitment] fully' or 'strengthen implementation', or more generally calling on UN member states to 'enhance', 'encourage', 'improve', 'promote', and so on. Perhaps more importantly, there was no accompanying analysis to

3 "Working document for 5–9 May session of Open Working Group", available at http://sustainabledevelopment.un.org/content/documents/3686WorkingDoc_0205_additionalsupporters.pdf (last accessed 13 May 2014).

4 See http://sustainabledevelopment.un.org/content/documents/4528zerodraft12OWG.pdf.

demonstrate that the targets identified as helping implement each specific goal will in fact be necessary or sufficient to actually attain that goal.[5]

The document was, nevertheless, far from its final form, which was agreed on 19 July.[6] The number of targets was reduced to 19 and have been grouped again by type of cooperation. The text remains quite general, the most generic target being 'Mobilise additional financial resources for developing countries from multiple sources' (target 17.3). Nevertheless, previously agreed specific targets are included, such as for the provision of official development assistance (target 17.2). Notable among the targets is to complement the global partnership for development with multi-stakeholder partnerships (targets 17.16 and 17.17). This suggests that the OWG is giving primacy to the global partnership as an intergovernmental undertaking, while also welcoming initiatives involving other partners. Only four of the global partnership targets specify deadlines for achievement, while most of the targets under the preceding 16 goals refer to 2030 as the target date. Perhaps the authors had 2030 in mind for Goal 17 as well, although they did not commit to it except in one case. In any event, the OWG says that the targets 'will be further elaborated through indicators focused on measurable outcomes' (para. 18 of the section on proposals of the OWG's report to the General Assembly, A/68/970). It is not said but it is probable that the indicators will be drafted by the Secretariat and perhaps would be approved by the General Assembly.

One might uncharitably call the set of targets for Goal 17 a 'shopping list' of mostly familiar policy proposals. It bears a striking resemblance (albeit updated) to Goal 8 of the MDGs, which has been roundly criticised since its launch in 2001, including recently by an interagency UN Secretariat team.[7] The formal wording of Goal 8 is 'develop a global partnership for development'; however, the targets and indicators of Goal 8 did not address how to build an effective global partnership, but rather proposed a selected list of substantive international policies that were at various stages of negotiation or implementation when the goal was launched, as appears to also be the case for Goal 17. Indeed, the content of Goal 8 did not compare well to the comprehensive and coherent package of domestic and international policy actions adopted in 2002 as the Monterrey Consensus on Financing for Development (A/CONF.198/11, Chapter 1, resolution 1, annex).

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5 For example, only one target is specified to help attain proposed Goal 4: 'Provide equitable and inclusive quality education and life-long learning opportunities for all'. The specified target would expand higher education scholarships 'by x%' by 2020, 'with a particular focus on science, engineering, health, economics, finance, management and sustainable development'. While important for adding to technical capacities in the mentioned fields, this target hardly seems to address the goal per se.

6 See http://sustainabledevelopment.un.org/focussdgs.html.

7 See UN System Task Team (2013).

3. Intergovernmental Committee of Experts on Sustainable Development Financing

The content of Goal 17 of the SDGs is important, because it differs markedly in approach from that taken by the other committee established by Rio+20 – the Intergovernmental Committee of Experts on Sustainable Development Financing. This Committee was mandated to propose options that the General Assembly would consider for an effective sustainable development financing strategy. At its meeting of 12–16 May 2014, the Committee started reviewing a 'zero draft' of its report, which is not in the public domain because the Committee meets behind closed doors. It was understood, however, that quite a different draft would be prepared for the members' review, and that they would have an opportunity to work on it so that a further subsequent draft would be tabled at the last scheduled meeting on 4–8 August.

Although details of the Committee's deliberations are not available, the nature of the approach that the Committee took was described by its co-chairs, Ambassador Pertti Majanen of Finland and Mr. Mansur Muhtar of Nigeria, who at the time was an Executive Director of the World Bank. They issued a joint public statement at the end of the second session of the Committee on 6 December 2013 in which they reported on some major highlights of the Committee's discussions as of that point, which included the following:

> [...] it was agreed that the domestic and international policy environments as well as their level of coherence have a profound impact on the mobilisation of finance for sustainable development. Good governance at the national and international levels is a prerequisite for long-term investment, growth and stability. Experts also emphasised the importance of addressing additional issues critical to development financing, such as a fair multilateral trading system, external debt sustainability, and macroeconomic and financial market stability. Regional cooperation is also important for generating development finance and ensuring stability […] financing needs are large. […] Global savings are adequate, but are currently not being allocated where needed to achieve global sustainable development […] all types of flows will be necessary. […] Domestic resource mobilisation will be [a] critical element of public financing. […] ODA [official development assistance] will remain crucial for the eradication of extreme poverty […] ODA alone will not be sufficient, even if all countries meet their commitments. […] Private investment will also need to play an essential role in meeting sustainable development needs. Nonetheless, to date, private sector investment has been insufficient in many areas of sustainable development. The private sector is profit oriented and would require appropriate incentives to invest adequately in sustainable development. In particular, the current international financial system does not encourage sufficient long-term investment. Furthermore,

externalities are not priced into certain areas, such as the energy sector, which distorts production and consumption patterns.[8]

It may be appreciated that the approach of the Expert Committee was quite different from that taken in the Open Working Group. Indeed, the Expert Committee's approach was closer to that of the Monterrey Consensus.

4. Post-2015 development agenda

The negotiations on the declaration, which is to be adopted in September 2015 as the post-2015 development agenda, will face a number of coherence challenges. Negotiators will need to decide if the final form of Goal 17, as proposed by the Open Working Group, should be substantially revised by the Assembly or jettisoned in favour of the experts' proposals for sustainable development financing. Or, perhaps Goal 17 and a proposal from the expert group will both be adopted without addressing why Goal 17 reflects only some of what is contained in the text drawn from the experts' report – neither of which directly addresses providing concrete strategies to attain the specific, agreed SDGs.

Another challenge facing the post-2015 development agenda negotiators concerns what may be a presumed expectation – especially among developing country representatives – that the reason for holding a summit in September 2015 to announce the SDGs and the global partnership to attain them is that new pledges of international assistance should be made by donor governments, perhaps joined by pledges of intensified South-South cooperation and announcements of development funding increases by large private foundations. There might also be expectations of announcements of numerous voluntary 'partnerships', as has been the practice since the Johannesburg Plan of Implementation of the World Summit on Sustainable Development in 2002, although many such partnerships do not in the end materialise as announced, if at all. As of today, momentum does not seem to be building for major additions to official international resources for development cooperation, but perhaps this will change.

Without additional pledges of assistance, what is left is the announcement of the SDGs. As a developing country delegate said to this author in another context at another time, '[w]e do not need the UN to set our national goals and policies; we can perfectly well set our own goals and targets. What we want from the UN is cooperation in trade and financial policies to assist us in the removal of policies that impede our achieving our goals'. In this context, the decline in the volume of ODA in 2011 and 2012 must be sobering, even though it recovered in 2013 though with donor spending plans not promising any upward trend.[9] The talk in the donor community about 'leveraging' stagnant levels of ODA with private investment funds – which are not grants, after all – cannot be an encouraging substitute for a more positive outlook for ODA itself. The ODA outcome will

8 As posted on the Committee's website at http://sustainabledevelopment.un.org/content/documents/2898cochair2ndsession.pdf (last accessed on 11 May 2014).

9 See the press release from the OECD announcing preliminary 2013 ODA estimates and current prospects, available at http://www.oecd.org/development/aid-to-developing-countries-rebounds-in-2013-to-reach-an-all-time-high.htm (last accessed on 11 May 2014).

send a signal. It will affect the degree to which the post-2015 document is seen as inspiring or routine rhetoric from the UN. Yet even without ODA pledges, an inspiring post-2015 outcome could result if a set of different commitments is agreed upon at the FfD conference.

5. The Third International Conference on Financing for Development

Indeed, UN negotiators recently agreed to hold the Third International Conference on Financing for Development (FfD) in Addis Ababa on 13–16 July 2015 (see A/RES/68/279), which will be just before the September 2015 summit. Because the FfD meeting should be a more technical forum on trade, investment, and domestic and international financial policies than the summit would be – and if it embodies a holistic and comprehensive package of policy agreements, as is the intention – then the FfD meeting might be the forum that gives convincing shape to the 'global partnership for development'.

The FfD conference will be an 'international' conference, which – applying the meaning that was employed in the first FfD conference in Monterrey, Mexico – should be 'owned' not only by the foreign ministry-led UN, but also by the finance and development ministry-led Bretton Woods institutions and the trade ministry-led World Trade Organization (WTO), and should even engage central banks and other authorities responsible for financial regulation. The unique success of the first FfD conference was that governments agreed to pursue specific reforms that had been under consideration or had won a measure of interest in their specialised institutions and forums. They were combined to form a holistic and pragmatic agenda to which the Monterrey Consensus gave political support. Can this be done again? Perhaps, but it requires considerable discussion among government ministries and between government representatives at different international organisations. This approach also requires a commitment of a core of UN Missions.

It should be clear that the FfD approach, as encapsulated in the aforementioned Monterrey Consensus and the Doha Declaration made at the 2008 FfD review conference (A/CONF.212/7, resolution 1, annex) – like the approach of the Intergovernmental Group of Experts – did not seek to mobilise the financing required to attain a specified set of goals, but to finance an acceleration of development and reduction of poverty, per se. Thus, FfD has focused on concrete means to attain broad aims. Indeed, there were no MDGs when the preparations began on FfD in 1997. FfD was constructed in the wake of the Asian financial crisis of 1997, the Russian debt crisis of 1998, and the near meltdown of the global financial system in the same year following the failure of a single US hedge fund – Long-Term Capital Management. Similarly, the 2008 Doha review conference took place during the depths of the worst global financial crisis since the Great Depression. Not surprisingly, given the international economic environment at the time, the focus of the developing countries – which had been the prime movers of the FfD process in the lead up to both Monterrey and Doha – was on systemic failures, while accepting the quid pro quo required by

developed countries that developing countries also agree to focus on the need to strengthen their own domestic economic environments and financial structures. In addition, developed countries recognised the need to substantially increase ODA, and all agreed to make the assistance more effective and to consider developing innovative sources of international public financing.

The FfD policy discussions in the lead up to Monterrey, in particular, were pragmatic and purposeful, such as to facilitate greater domestic mobilisation of financial resources for public purposes and for private investment. FfD has also sought to create domestic and international economic environments that favour long-term financial flows, which are essential for development, and to minimise the disruptions to economic activity caused by international financial volatility, through more effective financial regulations. It also agreed to strengthen the voice and participation of developing countries in global economic governance – notably at the International Monetary Fund (IMF) and the World Bank – a process that continues today.

It is also important to note that FfD, in particular the Monterrey conference, was a success because the UN delegations that drove the process reached out to their colleagues in the finance and trade ministries in capitals and in the multilateral institutions, and because the management and staff of the Bretton Woods institutions and the WTO all saw the value of the project, as internationally active civil society organisations and experts in emerging market finance on Wall Street eventually did, too. Moreover, the World Bank provided considerable human resources to the UN Secretariat, and several member states made significant contributions to the FfD Trust Fund, providing resources not only to bring country participants and civil society members to New York, but also to send the Bureau of the Preparatory Committee to seek substantive exchanges with the Executive Boards of IMF and the World Bank and the WTO Committee on Trade and Development.

Nonetheless, not all of the initiatives in the preparation of the Monterrey or Doha meetings went as planned or went smoothly. There were strong differences that could have derailed the discussion at many points, but the vision that something new was possible in Monterrey and the political momentum it gathered over time overcame the difficulties. It seemed especially providential that UN delegations agreed to keep what became the Monterrey Consensus (and later the Doha Declaration) short.[10] Delegations also agreed in preparing Monterrey (unfortunately not also in preparing Doha) to minimise the focus on drafting the final text and to concentrate on the policy substance. Indeed, conventional face-to-face negotiations were only permitted in the last three days of the last week of the fourth and last Preparatory Committee session, when all sides felt strong pressure to complete the text and go to Monterrey to celebrate what they had created.

10 There was also playfulness among leading delegates preparing Monterrey who claimed, for example, that they needed to keep the Monterrey Consensus short because it would have to pass muster with finance ministers who had short attention spans.

As mentioned above, the unique success of the Monterrey conference was that governments agreed to work seriously towards specific reforms that had been percolating in their specialised institutions and forums, which together formed a holistic and pragmatic agenda to which Monterrey gave a measure of political urgency. Nevertheless, when the Monterrey Consensus was adopted, John Foster of the North-South Institute in Ottawa, speaking to the FfD Civil Society Forum, called it the 'Washington Consensus in a sombrero'.[11] He saw it as a fairly conventional text in terms of policy and rhetoric, as it appeared to those making a superficial reading. Another view recommended looking more deeply into the text, which had potentially broken new ground in international economic law and thus held out an important promise:

> The Monterrey Consensus focused on certain concrete and specific dimensions of development instead of dealing with the concept in an abstract and general fashion. (…) The intention was "to achieve measurable improvements in sustainable growth and poverty reduction" [citing the IMF/World Bank Development Committee Communiqué, 28 September 2002] (…) [It] unveiled the blueprint of a new partnership that focused on a shared responsibility between developed and developing countries. (…) It is thus critically important to ensure dynamic, participatory, and sustained implementation and follow-up; without this, the Monterrey Consensus will only add to the already bloated number of elegant, eloquent, and solemn declarations adopted at high-level Conferences and routinely consigned to the limbo of oblivion. (Haque and Burdescu, 2004)

Indeed, a number of governments and the Bretton Woods institutions maintained enthusiasm for Monterrey for several years, although it ultimately eroded as the leading participants in its birth moved to other postings and senior managers completed their service in the major organisations. International attention shifted elsewhere, especially among UN delegations, which had only sporadic engagement with FfD in between the conferences.[12] As a UN delegate mentioned to this author less than a year after Monterrey, 'we opened channels to the finance ministry, but we are not putting anything into the channels anymore and they are drying up'.

Admittedly, the preparations for the 2008 Doha FfD conference followed a more conventional UN negotiation path and were less successful, with less buy-in by the Bretton Woods institutions or by the major powers. In fact, FfD was sidelined when the major powers invited other members of the previously ministerial-level Group of 20 (G20) to meet at leaders' level two weeks before the Doha conference and began to formulate the concerted international programme to respond to the global financial crisis. However, even before the G20 meeting, preparations for the Doha conference had not embodied the same sense of joint international purpose as had Monterrey; in the end, the negotiations on the Doha

11 As quoted in Haffajee (2002).

12 On the build up to the Monterrey successes and the dissipation of its energy post-Monterrey, see Herman (2006).

outcome document became quite contentious, and extraordinary efforts were required to 'save' the Monterrey process from collapse during the conference itself.[13]

For the third FfD Conference to succeed, it will be necessary to return to Monterrey processes, which can build enthusiasm among governments and other stakeholders and make them want – each perhaps for their own purposes – to forge a new Monterrey Consensus. UN delegations would have to take the lead and reopen the channels to other ministries, and cut new ones in the instances where UN Missions had not actively participated in the Monterrey process. They will also need to involve the other major international institutions and forums pertinent to development. If they can do this, something important in the revitalisation of international cooperation for development can be achieved.

6. Deliver a real, not just a nominal, global partnership

Intergovernmental discussions about development at the UN and elsewhere enthusiastically embrace the phrase 'the partnership for development' to describe the policy package that is the main focus of the discussions. The term has been used since at least the 1960s to describe a set of policy commitments by all or a group of governments to advance the development of the developing countries (see Herman, 2013). It usually represents a joint pledge by governments to contribute individually to collective undertakings in specified policy areas. The commitments are stated in more or less concrete terms, sometimes with and sometimes without deadlines for action. The parties also usually promise to come together periodically to monitor their progress in implementing their commitments. Unfortunately, the implementation reviews frequently seem to disappoint. If the added precision of announced commitments was intended to obligate participants more firmly, the strategy appears to have failed. The question then becomes how to forge more reliable commitments.

One strategy that has been tried in recent years has been to move the locus of decision-making out of the UN and into forums in which decisions embodying effective commitments were expected to be easier to achieve. Two notable experiences in forging such international partnerships for development seem to offer some points for reflection. As detailed in the annex to this chapter, the G20's Seoul Development Agenda and the Busan Partnership for Effective Development Cooperation have each promised significantly more than they have been able to deliver.

The 2010 Seoul Development Agenda – and its successor, the 2013 Saint Petersburg Development Outlook – were drafted behind closed doors and with very limited opportunities for engagement with non-G20 governments, non-business civil society, or multilateral development actors not under effective control of the G20. The initiatives have raised suspicions of the G20's intentions, especially among civil society organisations that monitor global development

13 For a critical review of the status of negotiations as governments began to arrive in Doha, see Concord (2008). For a post-conference assessment, see Burke (2008).

trends and policies.[14] They have also been a point of concern for the Global Governance Group (GGG) of UN member states that are not members of the G20. The GGG has won a number of small victories in instituting G20 dialogues with the General Assembly and in increasing UN Secretariat participation in staff work provided to the G20 by multilateral institutions, ostensibly to broaden the range of voices heard in those reports.[15] Nevertheless, despite the presumed greater homogeneity of the G20 forum, the delivery on its development cooperation commitments can be described as uninspiring. Certainly, there are forums within the UN system where the technical proposals of interest that the G20 has sought to advance can be more universally vetted.

The 2011 Busan Partnership for Effective Development Cooperation is a follow-up to the 2005 Paris Declaration on Aid Effectiveness and the 2008 Accra Agenda for Action, which in turn can be said to have grown out of a global mandate to promote aid effectiveness in the Monterrey Consensus (A/CONF.198/11, Chapter 1, resolution 1, annex, para. 43). Since the beginning, the driving force has been the donor countries in the Development Assistance Committee, although as noted in the annex below, more of the proposed reforms to make ODA more effective have been undertaken by aid-receiving, rather than aid-providing, countries. This is not hard to understand. Aid-receiving governments have an obvious interest in better planning and oversight of what donors are contributing to their country. Also, the implied threat for non-compliance with donor reform requests is a loss of funds. For donors, there is less pressure to reform and there may even be parliamentary pressures and government audit requirements to follow the donors' standard procedures rather than using national systems. The agenda for aid effectiveness reform is actually a valuable one, addressing not only the essentially bureaucratic problems, but also improving overall aid efforts by bringing multiple donors together in 'mutual accountability' forums in aid-receiving countries. Indeed, the latter is a focus of the UN's own Development Cooperation Forum (see Bester, 2014).

The argument here is that policy-makers should look to the UN as the primary forum for forging the global partnership for development. Taking global decision-making outside the UN has never substituted for facing the need to drive towards a concordance of views among all the relevant stakeholders in a fully participative UN forum. This could be seen in a distant precursor of FfD. The oil embargo imposed by the Organization of Arab Oil Exporting Countries in late 1973 raised oil prices from US$3 per barrel to almost US$12. Soon after, developed countries agreed to a discussion agenda proposed by developing countries, and at a special session of the General Assembly in 1974 adopted the call for a New International Economic Order (NIEO). This was followed by another special session on the NIEO in 1975, which was unsuccessful. The discussion was then taken out of the UN and placed in an ad hoc, restricted membership forum called the Conference

14 Examples of critical global monitors of the G20's development agenda include the Bretton Woods Project, Heinrich Böll Foundation, Eurodad and Social Watch.

15 See, for example, "Letter dated 20 March 2013 from the Permanent Representative of Singapore to the United Nations addressed to the Secretary-General" (A/67/807).

on International Economic Cooperation, based in Paris (see Amuzegar, 1977). That also failed, and the discussions then returned to a special Committee of the Whole (COW) of the UN General Assembly in 1978–79, which was ultimately asked to prepare a global round of negotiations on development and international economic cooperation (resolution 34/138). It failed as well, and the 'global round' never took place – although a North-South summit was held in Cancún in 1981. By 1980, the potential for consensus on the NIEO had evaporated, and there was no longer any belief that a deal could be cut trading petroleum price stability for enhanced cooperation on international financial and trade policies for development.

Global negotiations require a global forum, but a global forum does not guarantee successful global negotiations. If agreement is limited among the parties, the negotiations will ultimately fail, whether debated in a small or large forum. Indeed, periodically in the 1980s and 1990s, the General Assembly was asked to launch a 'global round', which it declined to do each time, until international relationships among developed and developing countries had reached a point at which some UN Missions from the South and the North thought it worthwhile to try again for a comprehensive economic policy discussion. That effort began in 1997 in a cautious and exploratory way as Financing for Development, and resulted five years later in the Monterrey Consensus.

It is not clear whether the world has reached another FfD moment or, for that matter, a Millennium Declaration moment, which was an inspiration to many people and governments around the world. However, governments should try to find out as they prepare for 2015. If the preparations are successful, the dual meetings would be inspiring – in a manner unique to the UN – involving both the laudable SDGs and the post-2015 development agenda's promise to achieve them, complemented by a comprehensive set of pragmatic commitments to advance specific policy elements of international cooperation in the third FfD conference.

Annex: Selected experiences with 'global' partnerships for development

Considerable international attention has been paid to the specification of the MDGs and their targets and indicators as adopted by the UN. Progress in their implementation has been monitored annually by official bodies, reports to which seem to be carefully read outside of as well as inside the UN.[16] This is presumably intentional, particularly because civil society watchdogs lobby governments to live up to their commitments when the many gaps are identified. The approach of specifying goals, targets and indicators of development partnership has spread to other bodies, with no better overall success in delivering action on commitments. This is the case whether in a restricted group of countries that are meant to have forged a special sense of global responsibility – namely, the G20 – or in a large group of countries in which the targets are meant to apply only on a voluntary basis to those governments that wish to bind themselves to them – namely, the Busan Partnership for Effective Development Cooperation. It may be useful to keep these experiences in mind as the international community prepares the SDGs and the renewed global partnership to speed the attainment of those goals. It may also be time to fold those exercises into the global partnership for development.

The G20's Seoul Development Agenda

The Seoul Development Agenda for Shared Growth was adopted in November 2010 by the member states of the G20 (Group of 20, 2010a). Following the mandate from its Toronto Summit in June 2010, the G20 adopted a multi-year action plan at the following summit in Seoul to implement a set of development cooperation principles.[17] The plan listed numerous concrete policy promises with deadlines for achieving them, which it asked its Development Working Group (DWG) to monitor. The action plan aimed to help increase economic growth rates in developing countries – including through investments and policy measures in infrastructure, human resource development (focused on skills), trade (enhancing capacity and access), private investment and job creation, food security, growth with resilience (identified as social protection and facilitating remittance flows), financial inclusion (financial services for the poor), domestic resource mobilisation (taxation), and knowledge sharing (Group of 20, 2010b).

One or more 'actions' were specified under each of these nine pillars, although sometimes multilateral institutions and not the member states were

16 Official multilateral monitoring is coordinated by the United Nations in its annual *Millennium Development Goals Report* and *MDG Gap Task Force Reports* (both sets of reports available at http://www.un.org/millenniumgoals/reports.shtml, last accessed 14 May 2014), and by the IMF and World Bank in their joint annual Global Monitoring Reports (available at http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:23100866~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html, last accessed 14 May 2014).

17 The six Seoul development principles focus on: economic growth; global development partnership (specifically, between G20 and low-income countries); global or regional systemic issues; private sector participation; complementarity (i.e. adding value to existing development efforts); and outcome orientation (i.e. feasible, practical, and accountable measures).

held responsible for delivering on the actions. For example, the multilateral development banks were called upon to '[i]dentify infrastructure gaps, needs and funding requirements …' (Delivery target: June 2011). In some cases, delivery dates were stated in a general way, for instance: 'We call for support to build capacity in tropical agriculture technologies and productive systems' (Target: medium term). In other cases, target dates were omitted, for example: 'We agree to make progress towards duty-free and quota-free (DFQF) market access for the least developed countries.'

In all, the G20 called for considerable activity by the multilateral system to prepare the reports required by its agenda and help initiate pilot projects. Commitments grew as additional DWG proposals were accepted by the G20 leaders. By 2013, there were 67 specific and time-bound cooperation commitments. In its 2013 report on their implementation, the DWG concluded that 33 of its commitments had been completed, 33 were 'ongoing' (although 8 were 'off track'), and only one had 'stalled' – namely, 'assess how best to integrate environmental safeguards in a cost-efficient manner'.[18] Nevertheless, quite a few pilot projects had been initiated, which could have broader impact depending on assessment of their results and follow-up.

According to some commentators, the criteria for awarding positive scores were less than demanding.[19] An assessment of the commitments by a joint Canadian and Russian academic project – based on data available up to 31 October 2012 – also offered a number of critical comments, if in a nuanced way.[20] A third assessment – which focused on infrastructure, food security and financial inclusion – saw a 'moderate' positive impact of the development agenda (Coplin, 2013). In addition, a Commonwealth survey of the views of its member states pointed to mixed evaluations by non-G20 members. The commitments to give 'support to developing countries to strengthen and enhance social protection programmes' and to 'enhance trade capacity and access to markets' received the lowest marks. Commonwealth countries were most satisfied with the commitment to facilitate the flow of remittances (Hou and te Velde, 2013, p. 8). However, it is also important to recognise the essentially subjective nature of all such assessments. In the latter case, the DWG itself assessed the commitment

18 "Saint Petersburg Accountability Report on G20 Development Commitments", St. Petersburg, September 2013, available at http://www.g8.utoronto.ca/g20/summits/2013stpetersburg.html (last accessed 6 December 2014) and https://www.g20.org/sites/default/files/g20_resources/library/Saint%20Petersburg%20Accountability%20Report%20on%20G20%20Development%20Commitments_0.pdf (last accessed 14 May 2014).

19 For example, '[s]upport for social protection floors is on-track, but it's not clear whether any countries are adopting them…. Moreover, little information is in the public domain about pilot projects or plans that are complete, such as the "action plan on water, food and agriculture"' (Alexander, 2013).

20 The assessment covered more G20 commitments than the development agenda per se; see HSE IORI and University of Toronto (2012), which was presented to G20 Sherpas Meeting in Moscow on 12 December 2012.

to reduce the average cost of remittance transfers from 10% of the amount of funds transferred to 5% by 2014 as 'off track'.[21]

The Saint Petersburg G20 summit took account of the official assessment and adopted a revised action plan based on five 'core priorities' – namely, food security, financial inclusion and remittances, infrastructure, human resource development, and domestic resource mobilisation. It thus dropped the pillars of trade, private investment and job creation, growth with resilience (social protection), knowledge sharing, and inclusive green growth (which had been added in 2012). Moreover, the 'stalled' action noted above, which fell under the retained infrastructure pillar, was dropped from further attention. Certain additional actions were added and most of the ongoing actions under the remaining pillars were continued, although some were dropped, including 'increase procurement from smallholder producers' under food security (which had been 'off track') and 'identify ways to help developing countries tax multinationals through effective transfer pricing', which had been part of domestic resource mobilisation (also 'off track').[22]

In all, while the G20 accountability exercise reflected the importance of monitoring and evaluation of partnership commitments and of periodically updating commitments, the exercise took place behind closed doors. Indeed, there seems to be no public explanation of the revisions made. Why, the public may ask, were the actions on environmental safeguards and social protection programmes dropped? Their omission suggests either that they were no longer priorities or deemed beyond the ability of G20 countries to deliver, or that the governments decided they had erred in seeking to address the specific policy question within the G20 *development* agenda, as opposed to other G20 working groups.[23] In fact, why had the safeguards commitment 'stalled' in the first place? Why were other commitments that had been deemed on track dropped before completion, including all the commitments that had not yet been achieved under the dropped trade and private investment and job creation pillars? The St. Petersburg changes beg for explanation.

For future assessments, the G20 promised at St. Petersburg to integrate accountability into its development cooperation work and undertake triennial performance assessments. It may be suggested that the G20 make such assessments openly and with the participation of relevant stakeholders, which

21 More generally, the path even to a highly quantified target can be judged in different ways – for example, by effort applied to reach the target or by a percentage of the target achieved (which implies that a linear approach to the target is realistic). Moreover, the target in this case largely pertains to prices charged by private corporations and their decline depends on costs and competition, which depends in turn on the volume of transactions within particular remittance corridors in a world of rapidly evolving technology. Thus, one may ask if this target was a forecast or a variable under policy control.

22 See "Saint Petersburg Development Outlook", September 2013, available at http://www.oecd.org/g20/topics/development/St-Petersburg-Development-Outlook.pdf (last accessed 15 May 2014).

23 For example, in 2014 the G20 had a separate working group on "investment and infrastructure". Also, in 2011, the work of the DWG on food security was largely overtaken by the G20 agricultural ministers who met and produced an Action Plan on Food Price Volatility and Agriculture (see Davies, 2014).

include not only the officially recognised 'engagement groups' (business, civil society, labour, think tanks and youth), but also other governments and peoples of the world. Indeed, there is a section of informed international opinion today that asks why the G20 has given itself the task of devising and undertaking a development agenda, most of whose beneficiaries would be non-G20 countries.[24]

In fact, the argument for according a role to the G20 in global economic policy has pertained not to development issues, but to macroeconomic coordination and consistent financial regulatory policies for global growth and financial stability. The case relies on a belief that a small group of major economies would reach good decisions that could move the global economy more quickly than is likely in a universal forum. Whether or not that is true, the argument does not seem to apply to international development policies. Certainly, G20 countries have not demonstrated a greater degree of solidarity in implementing their G20 cooperation proposals than their commitments in universal forums. Moreover, it is not as though smaller countries would not be the source of equally good ideas about development as those emanating from the largest countries in the world. All countries should be encouraged to bring their development policy proposals and initiatives to universal forums on development and in particular to the deliberations for the post-2015 development agenda and the third FfD conference.

Busan Partnership for Effective Development Cooperation

A different type of international partnership for development emerged from a sequence of high-level forums on aid effectiveness undertaken under the aegis of the OECD (OECD, 2009). It culminated in the Busan Partnership for Effective Development Cooperation, adopted by representatives of developed and developing country governments, international and bilateral institutions, and various other stakeholders.[25] As of March 2014, 161 governments and 54 organisations had endorsed the principles adopted at Busan.[26] However, the effectiveness-enhancing practices specified in the Busan agreement, which were largely carried over from earlier exercises, were not deemed to necessarily apply to developing country providers. Instead, it was explicitly acknowledged that the normative practices would be a 'reference for South-South partners on a voluntary basis' because the 'nature, modalities and responsibilities that apply to South-South cooperation differ from those that apply to North-South cooperation' (Busan Partnership, para. 2).

The Busan meeting had been motivated by a felt need to make official development assistance more effective and to encompass, within a broad effectiveness agenda, the burgeoning cooperation of non-traditional providers. In addition, Busan specified in what ways cooperation for effective development

24 See, for example, Callaghan *et al*. (2013).

25 "Busan partnership for effective development cooperation", adopted at the Fourth High-level Meeting on Aid Effectiveness, Busan, Republic of Korea, 1 December 2011, available at http://www.oecd.org/dac/effectiveness/49650173.pdf (last accessed 26 March 2014).

26 According to the post-Busan partnership website at http://effectivecooperation.org/about-list.html (last accessed on 26 March 2014).

should encompass more than what ODA per se generally can deliver – in particular, insisting on the need for 'strong, sustainable and inclusive growth' of developing economies, along with the need to support developing countries as they sought to increase tax revenues, strengthen state and non-state institutions, and deepen regional and global economic integration.

It must be noted that the pre-Busan efforts to boost aid effectiveness had reached their endpoint at the Busan meeting without achieving their goals. Even though considerable improvement had been recorded on many of the 13 pre-Busan targets, only one was achieved: 'technical cooperation programmes in *half* of the aid-receiving countries would be provided through donor-coordinated programmes that were consistent with partner national development strategies' [emphasis added] (see OECD, 2012). In other words, it seems that there had been some resistance – more so in a number of ODA-providing rather than aid-receiving countries – to carrying out pre-Busan pledges on aid effectiveness.

Those pledges had begun with a global endorsement in the Monterrey Consensus, which had spelled out a number of measures to boost aid effectiveness and called on ODA providers to apply those measures (A/CONF.198/11, Chapter 1, resolution 1, annex, para. 43). The Development Assistance Committee (DAC) – a coordinating body of donor agencies of OECD member states – took up the Monterrey challenge, forming a Working Party on Aid Effectiveness in March 2003 that was composed of representatives of donor agencies and multilateral institutions. In 2004, it invited 14 developing countries to join, and expanded again in 2008 to include representatives of civil society, organised under the Better Aid platform, which had been formed as the civil society vehicle for interaction with the DAC Working Party and its various thematic clusters.[27] Finally, developing countries that had become providers of assistance, ODA recipients, and the private sector were invited to participate. The Working Party helped prepare the Busan meeting and was called on to devise the working arrangements for the Busan follow up, a task it completed in 2012, after which it went out of existence.[28]

The post-Busan structure of meetings would henceforth focus on large-scale, multi-country and multi-stakeholder reviews about every two years to assess implementation of the Busan partnership. The first meeting of this new 'Global Partnership for Effective Development Cooperation' took place on 15–16 April 2014 in Mexico City. It had been prepared by a steering committee that is responsible for undertaking the preparatory and monitoring work between the large conferences. The composition of the steering committee mimics that of the earlier OECD Working Party, although it is smaller and has more developing than donor members. As of March 2014, it comprised representatives of five governments that receive development aid, one government that is

27 Better Aid was replaced by the CSO Partnership for Development Effectiveness at the end of 2012, carrying out similar tasks in the post-Busan partnership. For more information, see www.betteraid.org (last accessed on 26 March 2014).

28 See "Summary record of the Post-Busan Interim Group", OECD Working Party on Aid Effectiveness (DCD/DAC/EFF/M(2012)3REV2).

both a recipient and a provider of assistance, three government providers, one representative each of the private sector, parliaments, civil society organisations and multilateral development banks, plus the chair of the DAC, which remains the primary mechanism for coordination of Northern donors. The steering committee is chaired by three ministerial-level appointees.[29]

The global partnership and the steering committee are serviced by a staff team drawn from the OECD and the UN Development Programme. A major project of the staff team, completed in June 2012, was to devise a framework and a set of indicators by which developing countries could report their perceived improvements in the effectiveness of the development cooperation they were receiving (Global Partnership, 2013). The first round of reports under this methodology was presented to the Mexico meeting. It was a sobering report:

> Globally, the results are mixed (…) commitment to the Busan principles remains strong. Achievements made on important aid effectiveness commitments that date back to 2005 have been broadly sustained. (…) More needs to be done, however, to meet the targets that the Global Partnership set for 2015. (OECD and UNDP, 2014).

In light of the inability to report significant progress in implementing Busan commitments, it seems fair to query the role of this new forum. A communiqué was issued at the end of the Mexico meeting that reiterated earlier commitments and noted advances in various aspects of the Busan work programme.[30] However, the meeting did not promise accelerated action or seem to breathe additional political energy into the post-Busan process.

If the reason for creating the Busan process outside of the UN was the expectation of a greater ability to reach a strong commitment to undertake a set of specialised reforms, it does not seem to have been successful. Indeed, the donor resources devoted to the Busan process might well be better allocated to actual development cooperation activities, and additional political (and financial) capital might instead be invested in the UN's much more modest Development Cooperation Forum, whose members' commitment to effective development cooperation is no less strong. In fact, they include many of the same governments. Finally, while a number of interesting voluntary initiatives were described at the Mexico meeting – suggesting that the process may serve well as a platform for sharing experiences and perhaps stimulating participants

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29 Information as per the partnership's website at http://effectivecooperation.org/about/steering-committee/ (last accessed 24 March 2014).

30 While the communiqué largely followed the structure of the Busan agreement, it gave increased emphasis to middle-income countries, highlighting the vulnerability of a number of them, and the need of many for continuing development cooperation – which the communiqué emphasized should not be at the expense of aid to low-income countries ("First High-Level Meeting of the Global Partnership for Effective Development Cooperation: Building towards an Inclusive Post-2015 Development Agenda", Communiqué, 16 April 2014, paras. 23–26, available at http://effectivecooperation.org/wordpress/wp-content/uploads/2014/05/FinalConsensusMexicoHLMCommunique.pdf, last accessed 14 May 2014).

to emulate some of the initiatives – would it not be even more useful to share those experiences in a universal forum?

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PART TWO

FINANCING ECONOMIC SUSTAINABILITY

9

Debt Sustainability in Low-income Countries: The Grants versus Loans Debate in a World Without Crystal Balls[1]

UGO PANIZZA

1. INTRODUCTION

When allocating their international aid budget, development agencies must decide which countries they should target, whether to finance specific projects or provide general budget support, and whether to use their budget to give outright grants or use concessional loans that blend a grant and credit element. This chapter focuses on the latter choice.

A theoretical analysis of the basic tradeoffs between grants and loans suggests that the degree of concessionality should be positively correlated with initial debt levels and negatively correlated with future growth prospects.

A strategy based on the theoretical result that countries with an unsustainable debt situation should only receive grant financing requires an operational definition of debt sustainability. The World Bank/IMF Debt Sustainability Framework (DSF) operationalises the idea of debt sustainability by classifying low-income countries into three groups: low, medium and high risk of debt distress. The International Development Association (IDA) – the concessional arm of the World Bank – and several other donors use the DSF to allocate their aid budget.

While the DSF is a useful exercise with many objectives and potential users, the Framework is not necessary for deciding on grants versus loans. The decision could be postponed to the moment when the borrower should start repaying. With a system of GDP-indexed concessional loans, grants would be decided *ex post* (instead of *ex ante*) and the modalities (rather than delivery) of debt relief set *ex ante*.

1 A longer version of this chapter was first published as Ferdi Discussion Paper No. 120 (Panizza, 2015). It is based on ideas first discussed in a session on grants versus loans at the Marketplace on Innovative Financial Solutions for Development conference (Paris, 4 March 2010). I would like to thank Patrick Guillaumont for inviting me to write this chapter and Carlos Braga for inviting me to the Paris conference. I am also grateful to Enrico Berkes, Matthieu Boussichas, Tito Cordella, Jaime De Melo, Gail Hurley, Aart Kraay, Andrea Presbitero and Helmut Reisen for useful suggestions and comments. The usual caveats apply.

2. Tradeoffs

It is sometimes argued that grants are better than concessional loans because, by definition, they do not need to be repaid. For instance, former US Treasury Secretary Paul O. Neill stated that '[t]he World Bank has driven poor countries into a ditch by lending instead of donating funds to fight poverty.'[2] An alternative view maintains that grants are more expensive than concessional loans and that a move from loans to grants will bankrupt donor agencies.

Both views are wrong because they dismiss the fact that, for any given aid budget, a higher degree of concessionality implies a smaller transfer to the recipient country. However, the two policies do not have identical effects. The argument that grants are better than loans is only valid if funds transferred to developing countries have very small returns in terms of development. Perhaps grants and loans should be modulated according to their likely development impact, as suggested by Cordella and Ulku (2007).

There is a second, and more sophisticated, argument that favours grants over concessional loans. If private capital flows to a given developing country are fully determined by the country's ability to pay, any mix of grants and loans will lead to the same flow of external resources.[3] Therefore, the argument goes, it is better to let the private sector, with its superior screening capacity, decide on the allocation of commercial loans and have the official sector focus on pure grants (Meltzer, 2000). However, the result that any mix of grants and loans will lead to the same flow of resources is based on the assumption of perfect capital markets (Cohen *et al.*, 2007), and the sovereign debt market is rife with market failures (Panizza *et al.*, 2008).

Grants and loans may also have different incentive effects. Grants could be wasted and result in excessive government consumption and lower tax effort (Schmidt, 1964). Djankov *et al.* (2004) find that grants increase government consumption, but Morrisey *et al.* (2007) find that the choice between loans and grants has no effect on tax revenues.

Therefore, there are tradeoffs involved in the choice between grants and concessional loans. With grants, the recipient country does not have an obligation to repay, but it receives a smaller flow of foreign resources. With concessional loans, the recipient country receives a larger foreign transfer but it also accumulates external debt obligations.[4]

Cordella and Ulku (2007) develop a simple model that provides several insights on the basic tradeoffs between grants and concessional loans. In their model, the optimal degree of concessionality is positively correlated with the recipient country's initial debt ratios and negatively correlated with the recipient country's initial level of income and institutional quality, because institutional

2 http://www.nytimes.com/2002/02/21/world/treasury-chief-accuses-world-bank-of-harming-poor-countries.html.

3 Klein and Harford (2005) provide a simple example.

4 There are also differences for the donor agency. If there is a positive probability that a concessional loan will not be repaid, the loan has a higher expected cost, unless the default risk is factored in the computation of the degree of concessionality (see Roodman, 2014).

quality is assumed to be positively correlated with the ability to productively absorb external financing flows. Their results imply that grants should be directed to countries that cannot absorb large aid flows (as proxied by low institutional quality), have low growth prospects, and are likely to face debt sustainability problems. Countries with more favourable growth prospects and larger absorptive capacities can instead benefit from the larger flows of external resources associated with concessional loans.

Implementing the idea that grants should go to countries with unsustainable debt and concessional loans to countries with sustainable debt requires predicting debt sustainability in the distant future.

3. The Debt Sustainability Framework as a crystal ball

The Debt Sustainability Framework, which has the objective of 'assessing whether a country's current borrowing strategy may lead to future debt-servicing difficulties' (World Bank, 2006a, p. 28), is IDA's crystal ball for evaluating debt sustainability and deciding between grants and loans.[5] IDA financing decisions are not part of the DSF; they are policies based on the results of the DSF.

In practice, the DSF consists of two main elements: (i) a methodology for projecting the evolution of the net present value of five debt ratios under different scenarios; and (ii) a set of debt sustainability thresholds that depend on the quality of policies and institutions as measured by the Country Policy and Institutional Assessment (CPIA) index built by World Bank staff. In the Framework, countries with stronger policies and institutions are deemed able to sustain higher debt ratios, as originally shown by Kraay and Nehru (2006) and corroborated by a number of World Bank and IMF follow-up studies.[6]

The evolution of debt ratios is based on a standard debt dynamics equation in which the change in debt depends on the future behaviour of GDP growth, inflation, the exchange rate, foreign direct investments and the current account deficit. As IDA loans tend to have long maturities (ranging between 30 and 40 years) and long grace periods, the DSF requires long-term projections.[7] DSF documentation specifies a 20-year requirement for macroeconomic projections (World Bank, 2006a, p. 16) and a 50-year requirement for debt service projections (p. 17).

DSF projections consist of a baseline, two alternative scenarios, and six bound tests. While the baseline can differ from the historical scenario, it is rarely far from this scenario. The IMF staff guidance note states that a 'situation where debt ratios are significantly lower in the baseline scenario than in the historical scenario may indicate excessive optimism and should be explained' (IMF, 2013, p. 23).

5 For more details, see Panizza (2015).

6 For a review, see IMF (2012).

7 One example of and IDA loan is the ID 40. This loan has a 40-year maturity, a 0.75% interest rate, a 10-year grace period, and a 63% grant element (evaluated with a 5% discount rate). After the grace period, the loan has a back-loaded repayment profile. The borrower repays 20% of the principal during years 11-20 (2% per year) and the remaining 80% during years 21-40 (4% per year).

The Framework classifies low-income countries into three groups and IDA uses these groups to guide its lending decisions. The first group includes countries for which all debt indicators are below the relevant thresholds and for which the baseline and alternative scenarios and the bound tests suggest that debt ratios are not expected to break the thresholds during the forecast period. These countries are characterised as low risk (or 'green light') and receive 100% IDA concessional loan financing.

The second group includes countries for which the baseline projections do not indicate a breach of the debt thresholds, but for which the thresholds could be breached under alternative scenarios and bound tests. Countries that belong to this group are classified as having a moderate risk of debt distress (or 'yellow light') and receive 50% IDA loan financing and 50% IDA grant financing with a 10% reduction in flows compared with green light countries.

The third group includes countries for which the baseline scenario indicates a breach of the relevant thresholds. Countries in this group are classified as high risk (or 'red light') and receive pure IDA grant financing with a 20% reduction in flows compared with low-risk countries with similar characteristics. A country is classified as high risk if one of the five debt indicators breaches the threshold, irrespective of the behaviour of the other four indicators. Berg *et al.* (2014) label this characteristic of the DSF the 'worst-case aggregator'. They show that this aggregation scheme makes the DSF too conservative, even when evaluated with its own loss function.

3.1. Problems with the crystal ball

There are three problems with the DSF: (i) long-term forecasts of macroeconomic variables are unreliable; (ii) the bound tests of the DSF imply an asymmetric loss function; and (iii) independent researchers cannot assess the robustness of the relationship between debt sustainability and CPIA scores.

Long-term projections are unreliable

An aid agency interested in evaluating a country's ability to repay a concessional loan with 40-year maturity, a 10-year grace period, and a heavily back-loaded payment schedule (see, for instance, the ID 40 loan discussed in footnote 7) will need long-term forecasts for the borrowing country's main macroeconomic variables. I use a simple exercise to evaluate the out-of-sample performance of the historical forecasting procedure suggested in the DSF template (which is unlikely to deviate substantially from the baseline). I start by using average real GDP growth over 1980-90 to estimate GDP growth over 1990-2010, and then compare my forecasts with actual GDP for the year 2010.

The first row of the top panel of Table 9.1 shows the results for low-income countries. The most precise estimate is for Togo (actual GDP in 2010 was 9% of higher than my forecast). Forecast errors range between -77% in Mozambique and +220% in Zimbabwe. The standard deviation of the forecast error is 62% of GDP and the mean and median of the absolute values of the forecast error are 43% and 33% of GDP, respectively.

Table 9.1. *GDP growth forecast*

Forecast period	Abs. value of forecast error			Forecast error		Best forecast
	Mean	Median	St. Dev.	Min.	Max.	
Low-income countries (22 countries)						
1990-2010	43%	33%	62%	-77%	220%	-9%
				Mozambique	Zimbabwe	Togo
OECD countries (22 countries)						
1990-2010	17%	12%	26%	-28%	103%	0.3%
				Ireland	Japan	Australia

Source: Own calculations based on World Bank's WDI data. Forecasts for 1990-2010 are based on 1980-90 data.

Next, I repeat the exercise using a sample of high-income OECD countries (bottom panel of Table 9.1). I find that the smallest forecast error is for Australia (0.3%) and that forecasts errors range between -28% (Ireland) and +103% (Japan). Average and median errors are 17% and 12%, respectively.

Blanchard (1990) argues that because of large forecast errors, long-term projections of macroeconomic variables cannot be used to build ideal indicators of fiscal sustainability for OECD countries. As forecast errors for low-income countries are much larger than forecasts errors for the OECD, one is tempted to agree with Wyplosz (2011) that the DSF represents mission impossible.

The alternative scenarios and bound tests imply an asymmetric loss function

The DSF addresses uncertainty by building alternative scenarios and bound tests, but there are problems with the alternative scenarios and bound tests approach. If we believe that the baseline is likely to be close to the historical scenario, there is only one true alternative scenario (that which allows for higher financing costs due to changes in the degree of loan concessionality by major donors). Moreover, the bound tests do not tell us much about what may happen in the long run (they only affect the long run if temporary shocks have a long-lasting effect). Finally, the bounds and alternative scenarios strategy implicitly assumes a very asymmetric loss function (Berg *et al.*, 2014). In the baseline scenario, the DSF implicitly assumes that errors associated with underestimating a country's ability to service its debt are much costlier than errors associated with being too conservative. The alternative scenarios and bound tests amplify this bias.

The conservative bias of the DSF may balance overly optimistic growth projections (Berg *et al.*, 2014). However, if the designers of the DSF thought that there is an optimistic bias in growth projections, it would have been better to address this bias rather than including another distortion.

Alternatively, it is possible that the cost of missing a crisis is indeed much larger than the cost of a false alarm. If this is the case, it would be good to have an open discussion on the relative costs of the two types of error and build the DSF on the basis of a loss function that reflects these relative costs.

Independent researchers do not have access to CPIA data

The close link between debt sustainability and the quality of institutions and policies was originally established by Kraay and Nehru (2006) and has been corroborated by several internal IMF and World Bank assessments (IMF, 2012).

Unfortunately, these studies cannot be replicated by independent researchers because the CPIA data are reserved.[8] Kraay and Nehru (2006) do their best to address this problem by showing that their results are robust to using publicly available measures of institutional quality. It would, however, be better if the research community could have access to historical series for the actual CPIA data that drive the IDA financing policy. At this point, the only critical evaluation of the DSF comes from IMF researchers (Berg *et al.*, 2014) who have access to the CPIA data. Greater data access by the whole research community would enrich the debate. Independent researchers should be able to assess the robustness of studies that, ultimately, guide public policy and the allocation of large amounts of public funds (in 2013, IDA commitments surpassed US$16 billion).

4. There is an alternative

A possible rebuttal to the discussion above is that there is no alternative. Decisions on grants versus loans need to be made, and an imperfect crystal ball is better than nothing. We can make some changes to the actual implementation of the DSF, the argument goes, but the grant versus loan decision will still need to be guided by an instrument similar to the DSF.

However, it is not obvious why we need to decide now on a country's ability to service a debt that will not require any payment for the next ten years. Why shouldn't we postpone the decision and make payments contingent on the country's ability to pay? I will illustrate this idea with a simple example and then consider possible criticisms (including moral hazard).[9]

4.1. From ex ante to ex post grants

Consider a low-income country that is found to be at low risk of debt distress and an otherwise identical low-income country that is deemed to be at high risk of debt distress. Let us call these two countries G and R (green and red light, respectively). Further, denote π_1 as the probability that the DSF is right (i.e. that when payment starts ten years down the road, the debt of G will turn out to be sustainable and that of R will be unsustainable), π_2 as the probability that both countries will have a sustainable debt situation, π_3 as the probability that neither country will have a sustainable debt situation, and $1-\pi_1-\pi_2-\pi_3$ as the probability

8 CPIA scores are now available for LICs and MICs that are IDA eligible starting in 2005. Historical series are not available, and data for most middle-income countries (which are used in the econometrics exercises linking debts sustainability with institutional scores) are not even available for the post-2004 period.

9 I first proposed this strategy in Panizza (2010). Tabova (2005) predates my proposal but does not link GDP-indexed lending to the grant versus loan debate. The idea of using GDP-indexed loans to address the grant versus loans issue was, however, hinted at by Klein and Harford (2005). Guillamont *et al.* (2003) suggest making debt service conditional to commodity price shocks, Hausmann and Rigobon (2003) suggest transforming concessional lending in inflation-indexed domestic currency.

that the DSF is completely wrong (G will turn out to be unsustainable and R sustainable).

Under the status quo (SQ), IDA will make a concessional loan of, say 100, to G and give a grant of 80 to R. Further, assume that the concessional loan is similar to the ID 40 loan described in footnote 4 and has a concessional element of 63%. The expected value of IDA's portfolio will be: $EV_{SQ} = 37$. For a total transfer of 180, the cost of this operation will be: $C_{SQ} = 180 - 37 = 143$.

Now consider an alternative in which both countries receive 100 and only repay if their debt turns out to be sustainable. Let us further assume that, if things go badly, countries will be able to repay a fraction of the amount due. Let $0 \leq \delta \leq 37$ denote the NPV of the fraction of the debt that is actually repaid by the countries with unsustainable debt. In this case, the expected value of IDA's portfolio will be:

$$EV_{index} = 37(1 + \pi_2 - \pi_3) + \delta(1 + \pi_3 - \pi_2)$$

Given a total transfer of 200, the cost of this operation will be: $C_{index} = C_{SQ} + 20 + (37 - \delta)(\pi_3 - \pi_2) - \delta$. The difference in costs ($C_{index} - C_{SQ} = 20 + (37 - \delta)(\pi_3 - \pi_2) - \delta$) could be small, or even negative.

Moreover, $C_{index} - C_{SQ}$ is an upper bound of the additional cost of the alternative to the status quo. If G's debts turn out to be unsustainable, G is unlikely to repay the full amount due (i.e. it will receive *ex post* debt relief). Let us denote γ as the NPV of the amount of debt repaid by G under the status quo if its debts turn out to be unsustainable (with HIPC and MDRI, $\gamma = 0$; I assume $0 \leq \delta \leq \gamma \leq 37$). Then, the expected value of IDA's portfolio becomes $EV'_{sq} = 37 - \pi_3(37 - \gamma)$, and the difference in costs:

$$C_{index} - C'_{sq} = 20 - \delta + \pi_3(\gamma - \delta) - \pi_2(37 - \delta) < C_{index} - C_{SQ}$$

In Panizza (2015), I tabulate $C_{index} - C'_{sq}$ and show that that the cost of the alternative proposal is unlikely to be large (in fact, it could be negative).[10] This approach would be consistent with the risk-sharing nature of international financial institutions, as the additional cost would only be paid by countries that can afford to pay it. Missale and Bachiocchi (2012) go beyond my back-of-the-envelope exercise. They use VAR estimates and a CAPM model to evaluate the feasibility of GDP-indexed loans for concessional lenders and conclude that such loans would have limited risks and yield substantial benefits in terms of reducing the likelihood of debt distress.

One possible objection is that grant-only countries might not be interested in this indexation scheme. In the presence of perfect capital markets, the alternative proposal considered in this chapter makes grant-only countries worse-off. However, capital markets are not perfect. When countries go out and borrow the extra 20 – and they always try to do it, although sometimes they are not

10 The relative cost of indexing decreases quickly with π_2 and γ and becomes negative when $\pi_2 > 0.5$ or $\gamma > 20$.

successful – at a commercial rate, they normally pay interest rates that are well above the 5% discount rate used to compute the 63% concessionality element. It is possible that a loan of 100 with 63% concessionality will be cheaper than a grant of 80 and a commercial loan of 20.

Alternatively, countries with high growth prospects may not be interested. However, countries should not be allowed to choose because their payoffs are asymmetric. A country with strong growth prospects may be tempted to reject GDP indexation knowing that, if things go badly, it will receive debt relief *ex post*.

4.2. Challenges

There are also problems with the idea of addressing the grant versus loan challenge through GDP-indexed loans. The first possible problem is moral hazard, the second concerns the reliability of GDP statistics, and the third has to do with the fact that new lenders could free-ride on a policy that gives automatic debt relief at times of crisis.[11] There is also a class of problem that concerns indexed contracts in general. These problems include adverse selection, externalities in contract design, and excessive complexity.[12]

Moral hazard

The first objection to the proposal outlined in this chapter is moral hazard. If countries know that by growing less they will have to pay less debt, they may have less incentive to grow.

This is a red herring. It is easy to write theoretical models in which moral hazard is paramount. However, while moral hazard may play some role at the margin, it is hard to believe that moral hazard (at least moral hazard linked to concessional lending) is the reason why poor countries remain poor. Assume that a policy-maker needs to decide whether to transform her country into either South Korea (the only country that went all the way from IDA recipient to high income) or the Democratic Republic of Congo (the country with the lowest GDP per capita in the world) and chooses Congo in order minimise its debt repayments. Probably, this policy-maker should not receive development assistance.

Moreover, Froot *et al.* (1989) show that GDP indexation can be desirable even in the presence of moral hazard and describe the conditions under which GDP indexation is superior to indexing the debt to fully exogenous variables, such as commodity prices.

Unreliable GDP statistics

While it is hard to believe that policy-makers would try to maximise the welfare of countries by minimising growth, policy-makers may try to reduce payments by understating actual growth. Measurement is indeed a problem. While it would be difficult for a government to constantly understate GDP growth (after a few

11 Another possible issue is that flows are less predictable from the point of view of the donor country. However, the example of the previous section showed that this should not be a quantitatively important issue. Moreover, donor countries are probably better able to bear risk than recipient countries.

12 For a discussion, see Panizza (2015).

years, the level of measured GDP would be much smaller than the level of actual GDP), one could think about strategic behaviours whereby GDP growth is under-measured during years in which large payments are due. This problem could be addressed by smoothing repayment over long periods (as already happens with IDA loans) and with independent auditing of GDP statistics.

Free-riding by new lenders
New lenders may free-ride on the automatic debt relief delivered by indexing repayments to GDP growth. They may extend profitable non-concessional loans that benefit from the lower risk of debt distress implied by the indexation of concessional loans. This problem is not likely to be different from potential free-riding based on the current IDA framework.[13] Therefore, the free-riding problem can be addressed with the same debt limit policy used in the current framework (World Bank, 2006b). It would be also possible to provide incentives for private sector GDP-indexed loans and discourage non-indexed non-concessional loans with seniority rules.

5. Conclusions

Grants and concessional loans are different, and there are tradeoffs involved in the choice between these two instruments of development finance. Ideally, grants should be used for countries with an unsustainable debt situation and loans should go to countries that do not face debt sustainability problems.[14]

Debt sustainability, however, is hard to define and assess. In the current system, grants and loans are allocated on the basis of imprecise and conservative measures of debt sustainability. Indexing concessional loans to GDP would allow the grant-versus-loan decision to be postponed to a date at which both lenders and borrowers have more information on the capacity to pay.

In a sense, GDP indexation transforms *ex ante* grants into *ex post* grants. It would also simplify the debt relief process. It is plausible that some countries that are now deemed to have a sustainable debt situation will end up being in debt distress (because of war or natural disasters, or simply because their growth projections were too optimistic). If their debts end up being unsustainable, these countries will eventually receive debt relief. However, initiatives aimed at responding to unsustainable debt rely upon a patchwork of *ad hoc* measures. This approach is inefficient and sometimes inequitable. GDP indexation would define the rules for debt relief *ex ante* and thus increase predictability and efficiency.

GDP indexation may also have other benefits, as it may reduce the incentives for irresponsible lending (it could, however, create incentives for irresponsible borrowing) and thus reduce loan pushing and defensive lending.

13 An exact evaluation of the difference between the two approaches would require a detailed model that goes beyond the scope of this chapter.

14 In this chapter, I have assumed that the Framework only serves to evaluate debt sustainability. The conclusion might be different if the Framework and IDA lending strategy have the objective of providing incentives for policy reforms.

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10

Financing the Rise in Investment in Low-Income Countries: Boosting Domestic Savings is the Key

Bruno Cabrillac[1]

Following a lost decade in the 1980s, low-income countries (LICs) and low-middle-income countries (LMICs) enjoyed a rebound of growth in the late 1990s. Since the turn of the century, growth has risen sharply, outpacing that of advanced economies and, since the beginning of the Great Financial Crisis, even that of emerging economies. Episodes of sustained (five years or more) growth have also been more frequent (Bluedorn *et al.*, 2013). As a result, average GDP per capita in constant US dollars, which had declined in the 1980s and stagnated in the 1990s, has risen significantly, despite a protracted demographic transition. There has been more contrast in the evolutions of LICs than of LMICs. Specific features of the evolution in growth in sub-Saharan African (SSA) LICs and LMICs seem to be mainly linked to idiosyncratic cases of countries having undergone serious and long-standing conflicts (e.g. Rwanda, Ethiopia, Sierra Leone, Liberia and Angola) and/or having taken advantage of oil booms (e.g. Angola, Equatorial Guinea, Chad and Nigeria).

It comes as no surprise that this turnaround in growth accompanied a turnaround in investment rates. According to the economic literature, capital accumulation is a key, if not *the* key, factor of potential growth. While empirical evidence on the importance of investment in economic development is mixed, this is not the case for the recent episodes in LICs/LMICs (Bluedorn *et al.*, 2013).[2] Another striking feature of the macroeconomic evolutions of LICs/LMICs over the past 15 years is a significant and persistent increase in the current account deficit. In other words, the rise in investment has been largely financed by non-residents, as saving rates have remained stagnant. Two main factors have allowed this increase in foreign financing: external debt relief, notably under the Heavily Indebted Poor Countries (HIPC) initiative, and a global shift in capital inflows from debt to inward foreign direct investment.

However, there is no doubt that for this rise in investment to last long enough to trigger a take-off, there is a need to boost both domestic savings and sustainable sources of foreign financing. This requires a holistic approach covering global

1 The author thanks Emilie Debels, whose help was precious. This chapter represents the views of the author and should not be attributed to the Banque de France.

2 See also Chapter 3 in IMF (2014a).

governance, the business environment, macroeconomic policies, tax policy (saving incentives and public revenue mobilisation), financial sector development and financial inclusion, income distribution, exchange rate regimes, and FDI and remittances attractiveness. It also implies many difficult tradeoffs and fine-tuning.

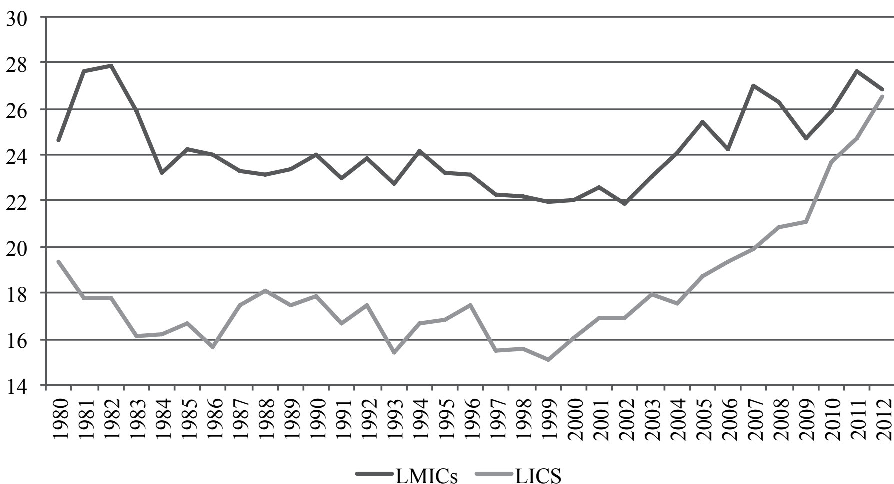
This chapter is structured as follows. Section 1 offers stylised facts about savings, investment and external financing trends in LICs/LMICs, with a particular focus on African countries. Section 2 tries to answer two questions: Are external financial flows growth to LICs/LMICs sustainable? Are there ways and means to attract more foreign private savings? Section 3 explores some avenues to increase and mobilise domestic savings in LICs/LMICs.

1. Investment, domestic saving, and external financing in LICs/LMICs: Some stylised facts

1.1. A significant increase in growth, GDP per capita and investment

LICs[3] and LMICs have taken advantage of a significant rise in investment during the last decade, after more than two decades of global stagnation. Since the beginning of the century, the non-weighted average investment rate has increased from around 15% for LICs and 22% for LMICs to above 25% for both groups. The evolution has varied across LICs and LMICs. Still, the rise has been a somewhat general movement and not the product of specific cases, as in both samples the standard deviation remained stable. SSA countries, both LICs and LMICs, have experienced the same increase in their investment rates.

Figure 10.1. *Average investment rate in LICs and LMICs (% of GDP)*



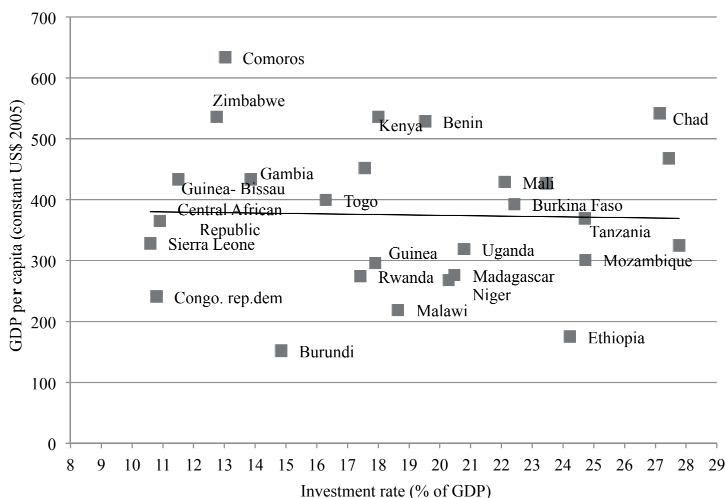
Source: World Bank.

3 On the basis of the World Development Indicators database for 30 LICs (including 24 SSA countries) and 41 LMICs (including 11 SSA countries).

At the same time, in both LMICs and LICs, GDP per capita in constant US dollars has increased notably over the last ten years after more than two decades of global stagnation. As with the investment rate, this has been a widespread movement and the standard deviation in both samples has not increased significantly. The temporal correlation between GDP per capita and the rate of investment has indeed been significant both for LICs and LMICs in the last 30 years, which is a common result in the literature.[4] Common sense suggests that the direction of causality is two-way: on the one hand, the accumulation of capital is a source of potential growth; on the other hand, the expectation of an increase in domestic demand, notably from a growing middle class, is the main driver for investment.

However, on average for the period 1995-2012, the correlation between GDP per capita and the investment rate[5] is significant and positive for LMICs but not for LICs (see Figure 10.2), which could be explained by two stylised facts. First, in some LICs, transfers from abroad have contributed to a large share of income. Second, capital accumulation generating a catch-up of GDP per capita is a slow process for very poor countries, even with high investment rates.

Figure 10.2. *Average GDP per capita and investment rates in LICs, 1995-2012*



Source: World Bank.

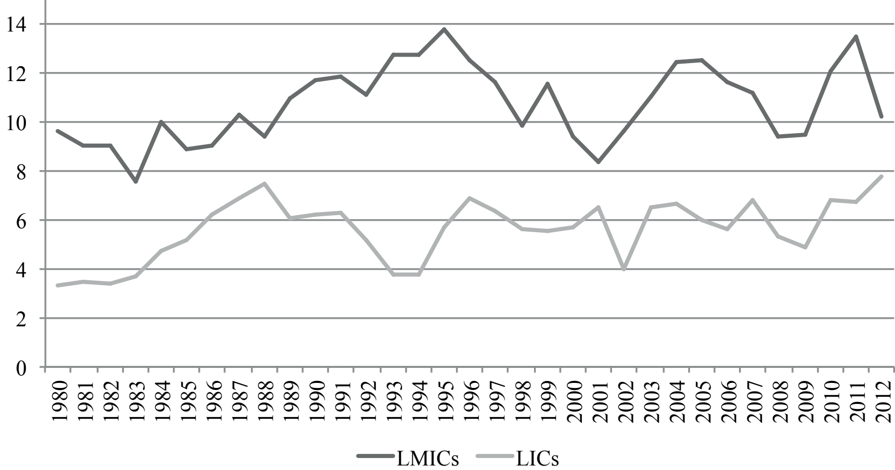
4 See, for example, Hausmann *et al.* (2005).

5 This is due to some specificities of this sub group, with a number of countries having high investment rate during the period and very low GDP per capita at the beginning of the period (e.g. Ethiopia, Rwanda, and Mozambique) and others with relatively high GDP per capita at the beginning of the period and a low investment rate during the period (e.g. Zimbabwe or Comoros). Higher investment rates have reduced but not suppressed the initial gap.

1.2. A stagnating domestic savings rate

At the same time, neither in the LICs nor in the LMICs was there a noticeable increase in the domestic savings rate, which remained within the long-term range of 5-7% of GDP on average for the LICs, and 10-13% for the LMICs.

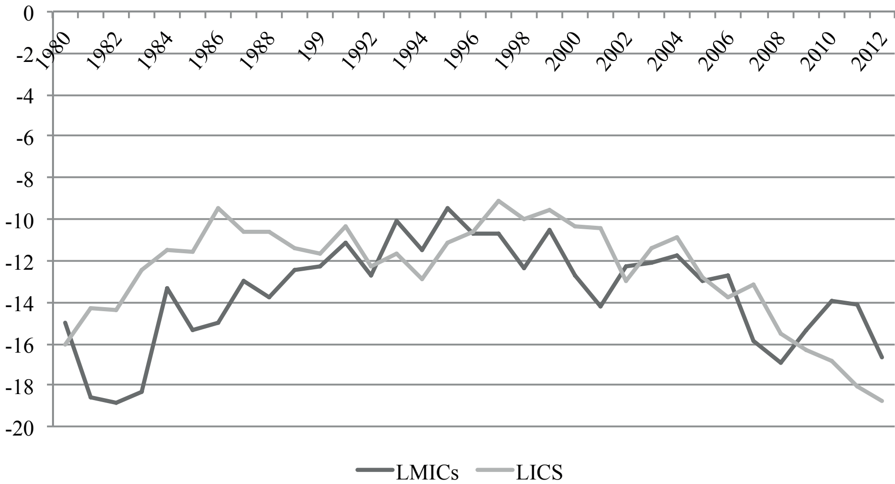
Figure 10.3. *Average savings rates in LICs and LMICs (% of GDP)*



Source: World Bank.

The imbalance between the average investment rates and savings rates has thus increased from 9% to over 18% for the LICs, and from 11% to over 16% for the LMICs over the last decade.

Figure 10.4. *Savings less investment in LICs and LMICs (% of GDP)*

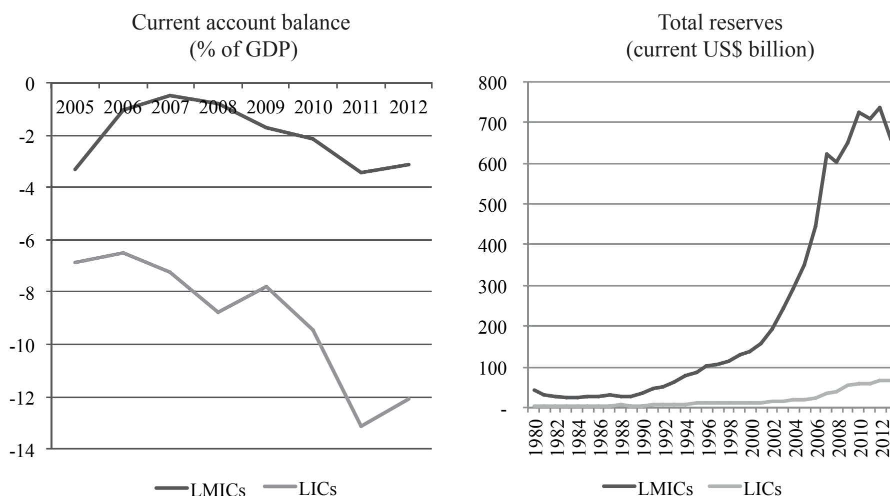


Source: World Bank.

1.3. The recent rise in investment has largely been externally financed

Hence, the rise in investment of the last decade has largely been financed from abroad, both by transfers (notably remittances and, to a lesser extent, official grants) and by a significant increase in capital inflows financing both an increase in current account deficits and an acceleration of accumulation of reserves. The average current account deficit increased to more than 3% of GDP in LMICs and 12% in LICs in the five-year period from 2008 to 2013. At the same time, foreign exchange reserves have increased in both samples – steadily in the LICs, and dramatically in the LMICs. Hence, over the last ten years both LICs and LMICs have benefitted from larger capital inflows than over the previous period, a trend that has been resilient to the Great Financial Crisis.

Figure 10.5. *Average current account balances and total reserves in LICs and LMICs*



Source: World Bank.

At first sight, this could been seen as a consequence of the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief (MDRI) initiatives,[6] which brought benefits to most LICs and to some LMICs during the last decade. Yet debt relief was accompanied by greater awareness of both creditors and debtors about debt sustainability issues, and the ability to borrow abroad remained constrained for most countries. Beyond the direct effects of the debt relief, the rise in capital inflows in LICs and LMICs has been the product of a global shift from debt to inward foreign direct investment and, to a lesser extent and in the last years, to portfolio investment.

6 The HIPC initiative was launched in 1996 and was supplemented by MDRI in 2005. Of the 44 eligible countries, 36 have benefited from the initiatives. The total debt relief is estimated by the IMF to be above US$70 billion.

The continent of Africa offers a good illustration of these evolutions. According to the *African Economic Outlook* (AfDB, OECD and UNDP, 2014), total external financial flows[7] to Africa could reach US$200 billion in 2014 (four times the 2002 amount) and 9% of GDP (compared to 6% in 2000), following a peak of 12% in 2006. The share of private financial flows increased from an average of 63% in 2000-2005 to 71% in 2010-2014. In particular, inward FDI has increased from under 1% of GDP in 2000 to over 5% in 2008, and remained above 4% during the Great Financial Crisis. The pattern is different for the subgroup of the 27 African LICs, as official development assistance (ODA) still contributes more than half of total external financial flows, despite the rapid rise of inward FDI since 2010. In African LICs, total external financial flows peaked at 20% of GDP in 2011 (compared to 13% in 2000 and 17% in 2014).

2. External financing will remain constrained for LICs and LMICs

2.1. External financing outlook for LICs and LMICs: Is the recent rise sustainable?

ODA remains a major source of external financing for LICs. The African Development Bank (AfDB) estimates that ODA flows will be equivalent to 9% of GDP of the SSA LICs in 2014. However, for African LMICs, this figure is less than 2%. In both subgroups, ODA has increased less than GDP over the last 15 years, and much less than the other sources of external financing. Although it is not the aim of this chapter to discuss the global outlook for ODA, there are three trends which could lead to mid-term pessimism over traditional ODA: (i) the protracted impact of the Great Financial Crisis on the public finances of most of the traditional donors; (ii) rising competing needs to finance global public goods, including climate change mitigation; and (iii) persistent doubts over aid efficiency. In a reflection on how to finance the post-2015 development agenda, even the World Bank has cast doubt on the prospect of increasing traditional ODA in the years to come (World Bank, 2013). Nevertheless, ODA to LICs is a specific case, as it will depend on two additional factors: (i) the evolution of the number and the size of LICs;[8] and (ii) aid needs generated by political and social crises, such as the Arab Spring.

LICs and, especially, LMICs have also benefited during the last decade from cross-border bank loans and, in the more recent period, from inward portfolio investments. According to AfDB, the global amount of net portfolio investment in African LMICs rose from 0.1% of GDP in 2000-2005 to 1.3% in 2010-2014, despite significant outflows in 2013. While still very limited, the amount of portfolio investment in LICs grew rapidly over the last three years as (i) some LICs (e.g. Zambia, Rwanda and Senegal) were able to access international markets for

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7 ODA + remittances + FDI + portfolio investments, excluding bank loans.

8 The take-off of some LICs could increase aid concentration rather than decreasing the volume of aid; see, for example, Tomasi (2013).

the first time, and (ii) some private equity funds began to invest in LIC markets.[9] An improvement in the macroeconomic fundamentals and business environment of LICs/LMICs is not sufficient to explain these flows. The pressing need to diversify portfolios, together with the relatively low correlation of LIC financial asset prices to those of the rest of the world and the search for yield during both the Great Moderation and the period following unconventional monetary policies in the advanced economies, were the main drivers for opening this window of opportunity. Against this backdrop, the foreseeable global tightening of financial conditions could trigger a re-pricing of LIC/LMIC risks and portfolio investment net outflows.[10] In Africa, where the total level of sovereign bond issuances could reach an historical high of US$15 billion in 2015, most observers think that the risks are globally underpriced. In October 2014, the IMF, addressing mainly LICs (Ghana, Rwanda, Tanzania and Uganda), stated that '[i]n such an environment countries where significant external needs have been increasingly filled by tapping international markets could find it difficult to do so' (IMF, 2014b).

Remittances have also been a very dynamic source of financing for LICs/LMICs in the last decade. According to the World Bank, global remittance flows reached US$500 billion in 2013, and more than 80% of these were going to LICs/LMICs. In addition, according to the World Bank and the IMF, if remittances sent through informal channels were to be included, this figure could be 50% higher (Freund and Spatafora, 2005; Gupta *et al.*, 2009). Remittances to Africa reached US$63 billion in 2013. Flows increased dramatically during the last decade, resulting in the official remittances per capita reaching US$58 in 2013, compared with US$18 ten years earlier. For some sizeable LICs/LMICs, this represents a substantial share of their GDP (e.g. more than 10% for Senegal and more than 7% for Nigeria). At the global level, remittance levels should benefit from the global recovery and weak or negative demographic growth in advanced economies and in some emerging economies. But there are potential negative factors, such as persistent slow growth and high unemployment in advanced economies, a strengthening of migration restrictions, and a lower willingness to transfer. However there is no doubt that remittances could be one of the most promising sources of external financing for LICs/LMICs.

Another promising source of external financing is inward FDI. As mentioned in Section 1, FDI to Africa grew significantly in the last decade. This benefited LMICs and also, more surprisingly, LICs. The common story behind this rise in FDI is investment by emerging countries in the commodities (mainly oil) sector. While this is part of the story, it should be noted that resource-rich countries' share of inward FDI in Africa decreased from 78% in 2008 to 65% in 2013, and that FDI has become more diversified across sectors (the Herfindahl index for sectorial concentration fell from 0.43 in 2003 to 0.14 in 2012) (AfDB, OECD and UNDP, 2014). In non-resource-rich African countries (mostly SSA LICs), inward FDI amounted to 4.5% of GDP in 2012, compared to 2.2% in resource-

9 The amount of private equity deals reached $4 billion in 2013, according to an East Africa Private Equity survey

10 As was the case in 2013, following the announcement of tapering by the Fed.

rich African countries. While a reversal in the long-term relative appreciation of commodity prices (and an improvement in the resource-rich countries' terms of trade) could deal a blow to FDI flows to African LICs/LMICs, it could spare most resource-poor LICs.

2.2. Ways and means to foster dynamic sources of external financing: The role of the international community

LICs/LMICs can mobilise a great range of domestic policies ('good policies, sound institutions') to attract private foreign savings. The next section will touch upon this issue, as most of these policies are consistent with those required to boost domestic private savings. In this section, we focus on specific measures in the source countries to support remittances and FDI to LICs/LMICs. Furthermore, as capital flight is an important impediment to domestic savings mobilisation, we consider how the international community can help to curb it. Finally, increased exposure of LICs/LMICs to private sources of external financing also means a greater vulnerability to volatility in capital flows. The international community should help manage this volatility, including through specific facilities.

As remittances began to outpace official development assistance, ways to boost remittances in the source countries began to be explored. Launched more than ten years ago, the G7 Global Remittance Initiative, which was later endorsed by the G20, focused on the barriers to remittances reaching the final recipient: lack of trust and access to financial institutions, limited competition in the provision of remittance services, and weak infrastructure. The G7 countries committed to reducing transaction costs of remittances. The supply of new products, such as diaspora bonds or dedicated saving accounts (whether benefiting or not from tax incentives), aimed at boosting remittances is another avenue being explored. Regulation that is neither too lax nor too strict, in particular to meet the requirements of international anti-money laundering standards, is also an important piece of the puzzle. As remittances largely flow through 'corridors', cooperation between the authorities at the two ends of these corridors should be sought.[11] Beyond improvements in the supply of remittance services, work done by multilateral development banks has shown that remittances are the product of an ecosystem that fosters, or at least does not impede, migration. However, due to the sensitivity of the issue, less attention has been given by the authorities of source countries[12] to this particular key aspect of the problem.

FDI to LICs/LMICs is essentially a market process, mostly driven by pull factors from the recipient countries. Source countries have generally supported FDI to developing countries by providing or subsidising guarantees and risk insurance to substitute for or supplement the market, while emerging economies have been using more diversified tools to do so. Until recently, this has been more a matter of industrial policy than of development policy. But the recent emphasis of the international community on long-term investment,[13] particularly

11 World Bank work on the Canada-Caribbean remittance corridor, for example.

12 It is also a sensitive issue for countries of origin, due to brain drain concerns.

13 Long-term investment, notably in infrastructure, is one of the few top priorities of the G20.

in infrastructure, has underlined the catalytic role of the public sector in boosting FDI to LICs. Both multilateral development banks and source country governments can help in (i) disseminating international standards and good practices; (ii) providing technical assistance (for example, in PPP or negotiations with private investors); (iii) reducing information asymmetries and increasing trust; and (iv) fostering the development of new markets and products, such as as project bonds. Viewing fostering private FDI to LICs as part of the framework of public development policy should also encourage source countries to prevent unfair deals, including unfair tax-base sharing.

Finally, including tax expenditures linked to incentives for remittances, or public expenditures linked to the provision of guarantees or risk insurance for FDI to LICs, in the OECD Development Assistance Committee's (DAC) measures of official aid could encourage advanced countries to implement these measures.

Helping LICs to limit capital flight should also form an important part of policies to foster sources of external financing for LICs. As noted by the World Bank and the UNDP, curbing illicit financial outflows is a key challenge. The range of estimates of capital flight from developing countries is wide (Reuter, 2012), but there is a clear consensus that it is larger than ODA flows. Indeed, on the basis of balance of payments data, PERI estimates the capital flight from SSA between 2000 and 2010 to have been more than (2010 constant) US$350 billion (Boyce and Ndikuma, 2012). This figure is to be compared with ODA flows of US$280 billion. The bulk of capital flights originate from oil-producing countries. Tax avoidance through profit-shifting by multinational corporations, notably in the commodity sector, is an important source of capital flight. The recent G20/OECD initiatives to fight tax optimisation (the Base Erosion and Profit Shifting, or BEPS, project) and to set up automatic cross-border exchanges of information could be important steps to curb tax evasion and, in turn, capital flight from LICs, provided that the international community is mindful of allowing LICs to take full advantage of these initiatives, notably through technical assistance and capacity-building.[14]

The negative effects of macroeconomic volatility in LICs (and, to a lesser extent, in LMICs) are an important impediment to sustained growth, as LICs are particularly vulnerable to swings in commodity prices, natural disasters and external financing. As argued by Patrick Guillaumont, vulnerability to economic volatility is one of the main elements of the LIC poverty trap.[15] Increased exposure to external financing has increased the vulnerability of LICs/LMICs to negative spillovers from the rest of the world. Being a significant factor of risk, this vulnerability is in turn an impediment to attracting more private external financing. In response, LICs/LMICS have self-insured by hoarding foreign exchange reserves. Nevertheless, the opportunity cost of reserve accumulation is even higher in LICs and LMICs than in emerging economies, owing to investment

14 See also the G8 Lough Erne agreement (June 2013) on extensive cooperation against tax evasion and avoidance schemes.

15 See Guillaumont (2009).

needs and a scarcity of resources. The IMF is paying increasing attention to this issue – in March 2011, it published a framework for assessing vulnerabilities and emerging risks in LICs as part of a broader programme of work aimed at helping LICs to mitigate external shocks. In the last few years, reforms of the IMF/World Bank financing frameworks and tools have made them more flexible and responsive *ex post*. However, adjusting the MDBs' concessional allocation frameworks to fully take into account vulnerability to external flows volatility should be a work in progress. In addition, the IMF has underlined the need to increase *ex ante* support for curbing excessive self-insurance, and points at limited LIC access to contingent financial instruments. Against this backdrop, the international community could strengthen its efforts to foster the use of contingent instruments by LICs.

2.3. External financing cannot be a major source of financing take-offs

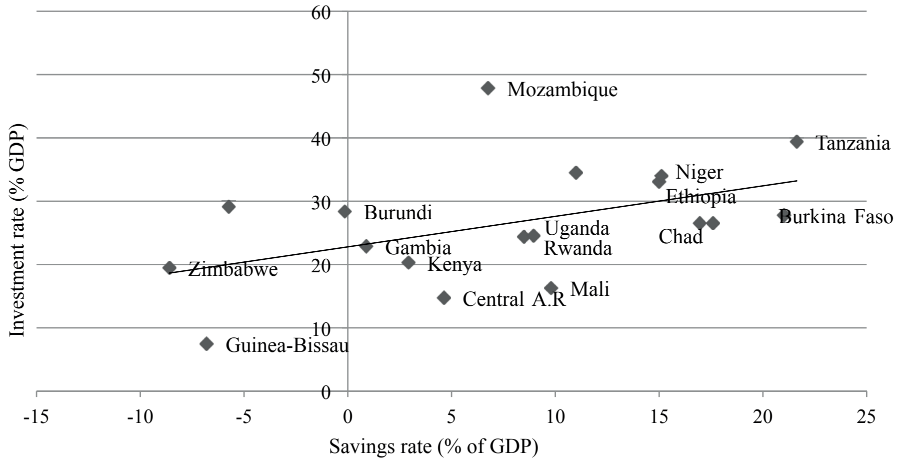
LICs have been able to finance large current account deficits and reserve accumulation with concessional resources. They will probably be able to continue to do so in the future, provided that they remain poor. Indeed, the foreseeable concentration of official development aid on the poorest and most fragile countries makes it improbable that ODA will make a large contribution to a sustained rise in investment and thus trigger an economic take-off, except in the first phase. Would private sources of external financing do the job? In a world of perfect information, clear property rights, flexible labour and capital markets, homogenous workers, identical savings preferences, and no asymmetric shocks, one would reasonably expect capital to move from advanced to developing countries. In the past, this has not been the case; most emerging countries have enjoyed, and are still enjoying, large current account surpluses or, at worst, limited deficits, and have been increasingly accumulating foreign exchange reserves. This conundrum has been well documented in the literature and its causes explored. As there is no reason why these causes would change,[16] it would be hazardous to base a take-off strategy mainly on external financing. Moreover, the necessary reduction of global imbalances could put more pressure on LICs' saving/investment balance. In fact, LMICs have an average current account deficit that is much lower than that of LICs. In the more specific case of African countries, the increase of private external sources of financing did not fully compensate the reduction of ODA for LMICs, triggering a reduction of external sources of financing relative to GDP since 2007.

3. Boosting domestic savings in LICs/LMICs

As external sources of financing will remain constrained, LICs and LMICs will have to continue relying mainly on domestic savings to finance any investment push needed for economic take-off. In LMICs, and even in LICs, the investment rate is strongly correlated with the domestic saving rate, both across time for each country and among each group, as illustrated by Figure 10.6.

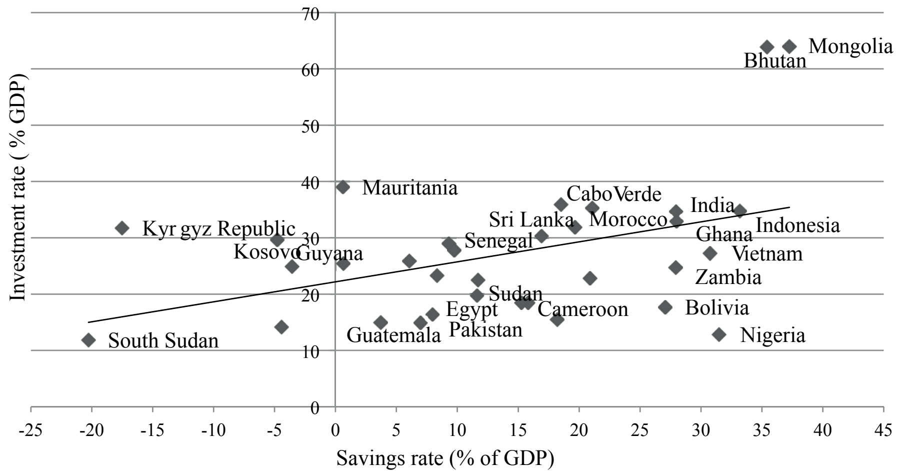
16 Although, as argued by Yang (2011), the rise of labour costs in large emerging economies such as China and India could trigger FDI from these countries to LICs.

Figure 10.6a. *Savings and investment rates in LICs, 2012*



Source: World Bank.

Figure 10.6b. *Savings and investment rates in LMICs, 2012*



Source: World Bank.

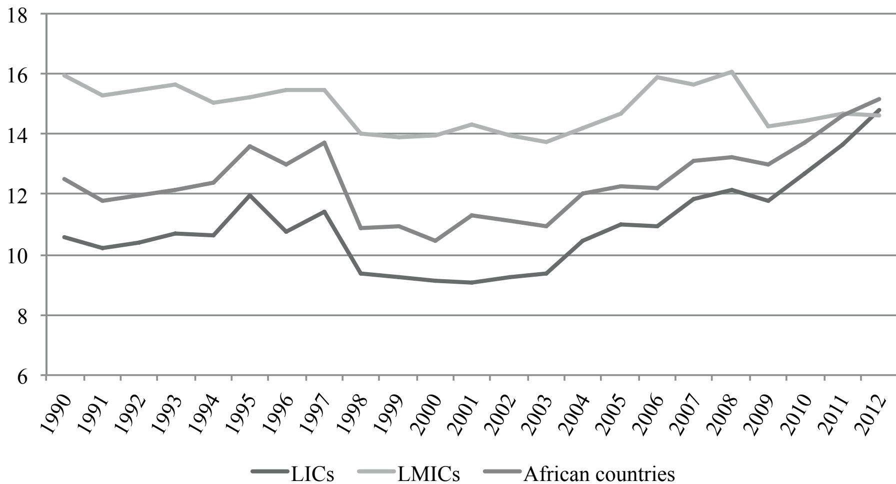
Much attention has been paid to the ways and means of better mobilising domestic savings for investment, but less attention has been paid to specific policies to increase savings, despite public revenue mobilisation having long been a concern. Even if public revenue mobilisation does not automatically generate savings, as additional revenue can be used to finance additional current expenditures, increasing tax effort normally generates more public savings.

3.1. Strengthening public revenue mobilisation

The Millenium Development Goals (MDGs), focusing on long-term public resource needs for education and health care, strengthened the international community's interest in public revenue mobilisation in recipient countries. In line with this, in 2005 UNDP estimated that LICs should increase their tax-to-GDP ratio by 4% to reach the MDGs. In addition, donors were increasingly concerned by the moral hazard arising from the substitution of aid flows for tax effort in many LICs.[17] In accordance with these concerns, donors have generally introduced public finance governance as a condition for aid, and in many LICs the tax-to-GDP ratio or similar indicators have been used as criteria for IMF programmes. However, the share of support for tax and tax-related activities in global development aid to African countries has stagnated at a low level (0.05%) since 2005 (AfDB, OECD and UNDP, 2014).

Tax effort (measured by tax revenue over GDP) is significantly lower in LICs than in LMICs[18] and *a fortiori* than in advanced countries. The recent increase in the ratio of tax revenue to GDP has generally been limited to resource-rich LICs/LMICs. The pattern for African LICs and LMICs is broadly similar.

Figure 10.7. *Tax revenues (% of GDP)*



Source: World Bank.

Although part of this revenue mobilisation gap is endogenous to the level of revenue and development, there is a consensus on the existence of significant room for improvement in most LICs/LMICs. International organisations and think tanks have come up with a large set of recommendations to fill this gap, most of which can be placed into three categories:

17 For example, the International Centre for Taxation and Development (ICTD), a research consortium financed by NORAD and DFID that began in November 2010 and is to run for five years.

18 See Chapter 11 in this book (by Jean-François Brun, Gérard Chambas and Mario Mansour).

1. Reforms with a wide scope but that can raise the willingness to pay taxes: good macroeconomic policies; political stability and fairness; rule of law; better governance, including expenditure transparency and the fight against corruption; decentralisation; improved access to (and quality of) basic services; and so on.
2. Reform of the tax system itself to make it less distortive, more efficient and more business friendly (e.g. substituting VAT for production and sales taxes, or limiting tax expenditures and exemptions).
3. Reforms aimed directly at improving tax collection, through improving tax administration functioning (capacity-building, IT investment, etc.) and honesty.

These three categories of reforms are interconnected. For example, tax administration integrity is connected to good governance, and a plainer and fairer tax system is a decisive factor in tax collection efficiency, which makes a holistic approach more efficient and, in most cases, necessary. Also, improving tax collection without improving the willingness to pay taxes, for example, could be counterproductive in the long term as taxpayers could react by stopping their activity. Discussing these reforms, which has been done extensively, is well beyond the scope of this chapter, which is intended to focus only on the policy tradeoffs of the intermediate objective of increasing tax revenue. Indeed, while the need for additional public revenues in LICs, and even in LMICs, is beyond doubt, increasing taxes is a double-edged measure and implies some macro and micro policy tradeoffs, such as the following:

- Reducing tax exemptions for FDI helps to improve the tax system (by reducing distortions) and at the same time helps to raise tax revenue, but it could also reduce attractiveness in a world where tax competition is not regulated.
- Taxing the informal sector also helps reduce distortions while increasing tax revenues, but it could endanger fragile business models.
- In some cases, increasing taxes on a small formal sector can foster rent-seeking, as it can constitute a barrier to entry.
- Increasing taxes could also have a crowding-out effect on private savings, which in the long run could have supply-side consequences.

3.2. Boosting private savings in LICs/LMICs

Domestic resource mobilisation cannot be limited to tax revenue mobilisation. Private saving mobilisation in poor countries has long been seen mainly through the prism of improving financial intermediation to better mobilise existing savings for investment. Increasing savings was seen more as an endogenous factor of, than a requirement for, growth and poverty reduction. As an illustration, while financial inclusion came progressively to centre-stage in reducing poverty, the main concerns were about developing access to credit rather than improving savings instruments for the poor. It took the global community a long time,

building on the experience of micro finance[19] (first known as micro credit), to realise how important savings are to financial inclusion. As noted by Josh Martin, 'the idea of expanding the diversity of savings mechanisms available to the very poor by facilitating their access to sustainable, voluntary saving services which will not wash away has increasingly gained traction among development practitioners in general, and among financial services providers who serve the poor, in particular' (Martin, 2013).

Indeed, it also took time for the development community to take into account the pressing demand from the poor for saving,[20] which today has been abundantly documented. This pressing demand stems from basic needs: insurance, consumption-smoothing, investment, and access to basic financial (means of payment) or non-financial (education, health, etc.) services. For the poor, these needs are exacerbated by higher vulnerability to adverse external events, higher volatility of income, and limited or non-existent access to social safety nets or to free public services. What is true for the poor is also true, *mutatis mutandi*, for LICs/LMICs. Hence, there is a strong case for public policies to target increasing private savings.

As for public revenue mobilisation, a large array of policies can foster private savings, including sound macroeconomic policies, sound and efficient financial intermediation, financial inclusion, targeted measures to foster an adapted supply of financial services and tax incentives.

3.2.1. Sound macroeconomic policies

Sound macroeconomic policy is the basic element of an ecosystem that is favourable to both investment (including inward FDI) and savings (including remittances). As far as savings are concerned, the most important of these elements is price stability. On this front, LMICs and LICs have made tremendous progress over the last 20 years. This was the result of broader progress in monetary, exchange rate and also fiscal policies. Other macroeconomic features of an ecosystem that is favourable to savings are more controversial, as they imply a difficult tradeoff. Financial repression (a negative real rate of returns on savings) is an impediment to savings while, at the same time, being a strong incentive for investment. Many long episodes of sustained growth, such as in Europe after World War II or in East Asia from the 1960s to the 1980s, were accompanied by long periods of financial repression. The choice between increasing taxes and preventing private savings from crowding-out forms another difficult tradeoff. Capital account liberalisation is also a factor which, through confidence effects, can help boost savings but also raises the risk of financial instability and, if associated with flexible exchange rates, of price instability where inflation targeting is not (yet) feasible.

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19 See papers by the Grameen Foundation or the CGAP.

20 Even if some research can be traced back in the 1980s.

3.2.2. Sound, deep and efficient financial systems

A sound financial system is the other basic element for fostering savings. For LMICs, and especially LICs, the key is a sound banking sector. On this front also, these groups of countries have made a lot of progress over the last decades. In most countries, the banking sector proved resilient during the Great Financial Crisis. In Africa, in particular, 'decades of regulatory upgrades have borne fruit in the form of more stable banking systems and substantially less fragility' (Beck and Cull, 2013). Indeed, banks' equity-to-asset and liquidity ratios were significantly higher on average in LICs and LMICs than in developed countries in 2012,[21] and were even higher in African LICs and LMICs. However, particularly in SSA, if there is no proper oversight, four factors could jeopardise this improvement in financial stability: (i) an increase in intra-continental cross-border banking flows, which could be potentially very volatile; (ii) the expansion of pan-African banking groups, which requires the coordination of regulators to be strengthened well beyond the present level; (iii) the nascent but limited shift from bank to market financing in LMICs, and even in LICs, if market regulation is not upgraded; and, more generally, (iv) financial innovation, as regulators have limited capacity to adapt themselves.

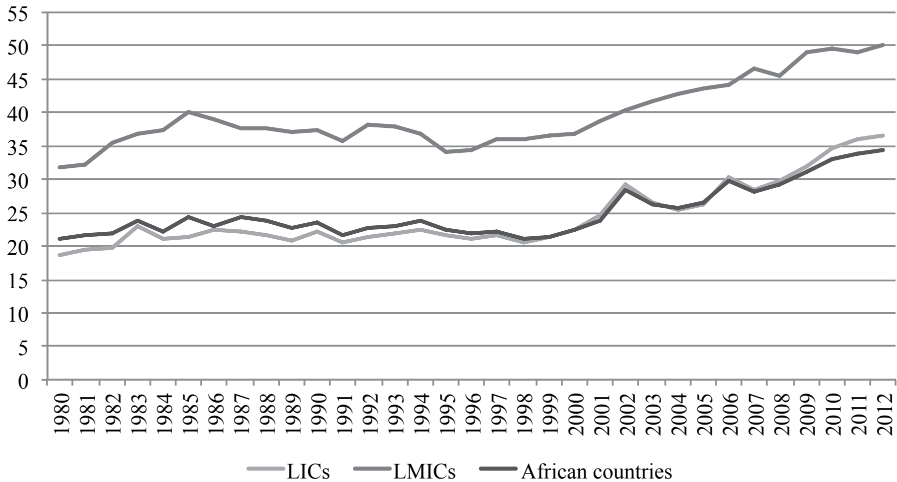
Furthermore, a sound financial system is a necessary but not a sufficient condition to foster savings. An inefficient banking system, supplying savings services at a high cost-to-benefit ratio, will not be attractive to savers. Yet, higher equity-to-asset and liquidity ratios could also signal inefficiencies, shallow markets or lack of competition. On average, intermediation margins of the banking sector (i.e. lending minus deposit interest rates) are significantly higher in LMICs and LICs than in other countries, and this is especially true of countries in Africa. In SSA, intermediation margins were 300 basis points higher than those in Latin America, and more than 500 basis points higher than those in the East Asia Pacific Region in 2013. As summed up by Beck and Cull (2013), 'African banks are less efficient than banks in other developing regions of the world and bank services are therefore more expensive…the higher interest rate spreads go hand in hand with greater concentration and lower competitiveness in African banking markets'. The concentration indicators for the banking sector are significantly higher in LICs than in LMICs, and in SSA countries than elsewhere, even though they have declined recently.

Both lenders and depositors pay a higher price for banking services than in other countries, but in most LICs and LMICs, as the banking system is overly liquid and as there are not enough alternatives to deposits, depositors are supporting the bulk of this surcharge. The prices of other financial services linked to savings (life insurance, listed financial assets, etc.) are also much higher in Africa than elsewhere due to shallow markets and lack of competition. For example, transaction costs on stock exchanges are excessively high. High prices are one impediment, *inter alia*, to access to savings services. Even though financial depth, measured by the ratio M2 on GDP, has dramatically increased

21 See Beck and Cull (2013) and Beck and Honohan (2007).

in the last 30 years in both LICs (from 20% to 35%) and LMICs (from 30% to 50%), it remains much lower than in other groups of countries, and much lower in Africa than elsewhere.

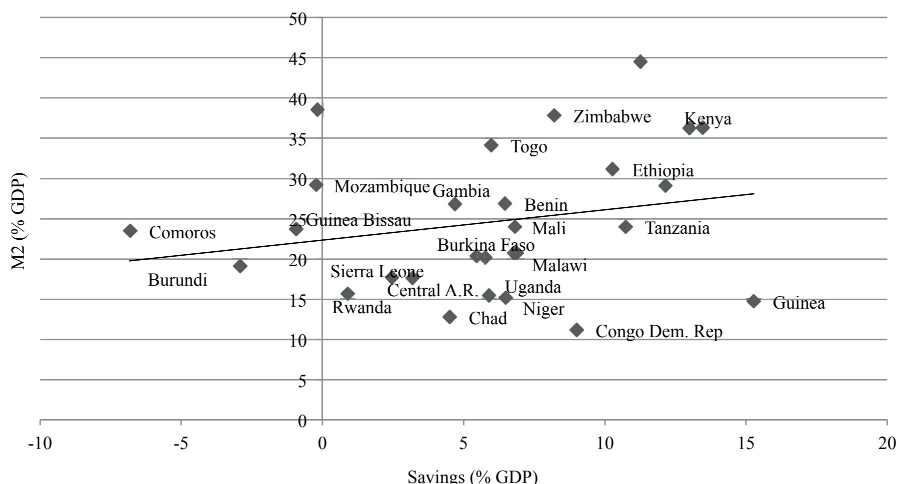
Figure 10.8. *M2/GDP in LICs and LMICs, 1980-2012*



Source: World bank.

In both LICs and LMICs, savings rates are also significantly correlated to financial depth and to other financial inclusion indicators, notably account penetration, although a lesson drawn from the FINDEX database is that account penetration is not entirely explained by financial depth. In SSA in 2011, only 24% of adults had an account with a formal financial institution, compared to 89% in advanced economies and 39% in Latin America. Another interesting finding from the same FINDEX database is that the percentage of adults saving money is as high in SSA as it is in the East Asia Pacific region (40% in 2011), although in most SSA countries (except South Africa, Kenya and Nigeria) fewer than 10% of adults are saving in formal institutions. Not surprisingly, account penetration in SSA is much more strongly linked to level of education than elsewhere and is significantly higher in urban areas. This link is even stronger for the percentage of adults saving in a formal institution. However, macroeconomic and social data cannot fully explain the low percentage of people saving in formal institutions in LICs and in SSA (Demirguc-Kunt and Klapper, 2012).

Figure 10.9. *Average savings rate and M2*



Source: World Bank.

A wide range of specific policies can be put in place to improve the functioning of the financial system, and more specifically the provision of savings products. Most of these, however, imply difficult tradeoffs.

First, the authorities should provide enough financial and human resources to regulators to address the challenges stemming from the rapid mutations of the financial sector in Africa, including enhancing cross-border cooperation. This comes at a price for governments, as financial institutions cannot pay the full cost of the regulation, or are likely to pass it on consumers.

Second, regulation should enhance financial stability without imposing excessive regulatory costs on financial institutions, notably banks and micro finance institutions. In the same vein, regulators should be careful to find the right balance between prudential and competition concerns. One good example of this necessary fine-tuning is the minimum level of capital for financial institutions.

Third, the best tool for lowering prices for financial services is to increase competition on the domestic market through the opening of the financial sector to foreign competition and lowering barriers to entry, including for cross-border bank flows. Regional financial integration, in particular in Africa, can accelerate this process. Fostering financial and technical innovation, such as mobile banking, also helps (Sy, 2014). Here, the tradeoff between financial sector efficiency and financial stability can be mitigated by enhancing regulators' skills.

Fourth, monetary policy should also give some attention to reducing the inefficiencies of the system. For example, structural excess liquidity and/or high reserve requirements weigh on the banking system, and the cost is likely to be passed on to consumers. Absorbing excess liquidity through market operations comes at a short-term cost for the central bank.

Fifth, a deposit guarantee scheme is also a key element, as savers need to have access to a pure safe asset. However, the moral hazard generated by such schemes for both depositors and banks should be taken into consideration.

3.2.3. Improving financial inclusion

An insufficient and unsuitable supply of savings products is also an important impediment to increasing savings, especially of the poor. FINDEX surveys show that saving behaviour is as widespread in LICs/LMICS as it is in the developed world, but the savings methods differ. In LICs/LMICS, informal methods of savings, either community-based or individual (in cash or in goods), are still predominant.

Field experiments based on randomised controlled trials have provided two main findings: (i) an adapted supply of savings products from the formal sector both attracts existing informal savings and raises savings; and (ii) this increase in formal savings generates a large range of positive externalities.

Hence, boosting savings and channelling them to the formal sector should not be simply a by-product of financial inclusion policies, but rather a main pillar. This involves many features of financial inclusion policy: (i) fostering savers' trust in a strengthened commitment of providers to client protection; (ii) supporting the development and the formalisation of savings groups, and including them as part of government's social policies targeted at women, youths, and so on; (iii) encouraging partnerships between all potential providers (savings groups, MFI, banks, insurers, mobile operators, etc.); (iv) encouraging alternative distribution channels for savings products, such as using digital technology and payments systems as an entry point for savings products;[22] and (v) designing products that at the same time are demand driven and foster saving behaviour,[23] including micro insurance products.

3.2.4. Specific policies to foster savings

Fiscal policy can also be used to incentivise savings through subsidising specific savings products or alleviating tax on savings. Specific policies to foster savings could include government intervention to design specific savings products targeted at specific goals (housing, retirement, education, etc.) and/or specific groups of the population (women, youth, the elderly, families, rural populations, etc.). Savings products, including those mentioned above, can be subsidised at two levels: (i) directly, by boosting the return for savers (including through tax exemption); and (ii) indirectly, by subsidising the distribution to lower the costs. This implies a tradeoff between potential distortions and efficiency.

At a more global level, tax policy is a powerful tool to incentivise savers. Effective tax rates on capital income, both at absolute and relative levels, are an important incentive for saving behaviour. The tradeoff with promoting savings

22 For example, M-Kesho (a partnership between M-Pesa and Equity Bank) offering mobile savings products in Kenya.

23 As shown in numerous studies, placing restrictions on the withdrawal of funds strengthens savings commitment and is desirable for protecting savings from external pressures.

includes not only public revenue mobilisation, but also income and wealth inequality.

Conclusions

The recent rise in investment in LICs/LMICs has been largely financed by external sources of funding. In the future, neither ODA nor external borrowing is likely to provide a sufficient share of the financing needed for take-off in these countries, so they should look to an increase of other sources of financing, such as remittances, inward FDI and domestic savings. Designing the ecosystem to foster this increase is a key challenge for LICs/LMICs, and encompasses a wide range of policies, including governance, macroeconomic policy, financial sector development, and financial inclusion. It also implies a specific focus on boosting domestic savings, as (i) inward FDI and/or remittances can provide only a limited contribution, and (ii) domestic savings should not be seen as a mere consequence of but also a requirement for development.

An active policy in favour of savings, notably involving financial sector reforms and tax incentives, implies difficult fine-tuning and tradeoffs. Opening markets, fostering innovation and competition, fine-tuning regulation, increasing empowerment of the poor, youths and women, encouraging saving behaviour, arbitraging between public resources, and private savings mobilisation are not always in the interests of politicians. As the political economy of these reforms is not easy, the donor community could help by providing technical assistance and incentives. Beyond these traditional tools, donors could explore a reengineering of ODA to include, where possible, a parallel goal of catalysing private external and domestic savings. This could be done in two ways: systematically promoting partnerships with the private sector, and providing what savers require the most, that is, confidence, through reducing but not distorting risks.

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11

Tax Effort of Developing Countries: An Alternative Measure

Jean-François Brun, Gérard Chambas and Mario Mansour[1]

Introduction

Developing countries' need for resources to finance public goods[2] that are essential for development has been a major focus of research since the 1960s. Alongside aid flows, government revenue[3] (tax and non-tax revenues) is recognised as an essential instrument for financing public goods. The 2002 Monterrey Conference underscored the critical importance of mobilising government revenue.

The importance of government revenue for financing public goods has led many authors to identify the determinants of these revenues and, from there, to evaluate countries' *tax potential*, or domestic government revenues that could be mobilised in view of each country's specific characteristics. The pioneering work of Hinrichs (1965), Lotz and Morss (1967) and Bahl (1971) defined the methods and key concepts required to assess tax potential.

Whilst the choice of observation period and sample countries may differ, the factors identified by analyses since the late 1960s have remained remarkably consistent. Most studies positively associate gross domestic product (GDP) per capita and the trade openness ratio with the level of government revenue, and negatively associate the relative contribution of agriculture to GDP, as well as socio-institutional variables such as the level of corruption.

However, mining[4] is an exception to this analytical consensus. Frequently considered by early studies as a key positive factor for government revenue, it was later often ignored, and has recently been found to be negatively correlated with government revenue (see Section 1). These contradictory findings as to the effect of mining on government revenue mobilisation cast doubt on the quality of assessments of tax potential based on total government revenue.

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1 The opinions expressed in this chapter are those of the authors and cannot be attributed to the International Monetary Fund, its management, or its executive board.

2 The concept of public goods is used in a broad sense to include public goods and services.

3 Unless otherwise specified, the term *government revenue* is used here in a generic sense; it relates both to tax revenues and total government revenue (the latter including tax and non-tax revenues).

4 In this chapter, we use 'mining' as a generic term synonymous to the mining of non-renewable natural resources (essentially, mining and oil and gas).

Recently, authors such as Thomas and Trevino (2013) have made conceptual progress by trying to explain *non-resource*[5] government revenue rather than total government revenue. By excluding *resource* government revenue, which is largely outside the reach of economic policy, non-resource government revenue as a dependent variable achieves much greater homogeneity than total government revenue. The resource component depends primarily on natural resource endowment, whilst the non-resource component is determined by both structural factors and economic policy. Furthermore, the statistics on non-resource revenues for the countries of sub-Saharan Africa gathered in 2013 by the IMF's Fiscal Affairs Department (Mansour, 2014), and the ICTD's 2014 study on a large sample of developing countries (Prichard *et al.*, 2014), have facilitated the econometric analysis of the determinants of non-resource revenues.

To overcome the foregoing difficulties in taking the impact of mining into account, we should now be able to evaluate potential non-resource government revenue, and replicate the innovative approach of Thomas and Trevino (2013) by considering resource government revenues as an exogenous factor potentially affecting non-resource government revenue.

As such, our aim is to evaluate the potential of non-resource government revenues and non-resource tax effort for all developing countries. To do this, we carry out a review of the literature on the determinants of government revenue (Section 1), examine the characteristics of the resource and non-resource components of government revenue (Section 2), analyse the factors of non-resource tax potential (Section 3) and, finally, assess the tax effort of developing countries (Section 4).

1. Tax potential and tax effort: Literature review

1.1. A constantly renewed interest in assessing tax potential

Following on from the various pioneering studies mentioned above, the econometric estimates (panel data regressions) by Chelliah *et al.* (1975) and Tait *et al.* (1979) went on to assess tax potential. Tax potential, as part of an analysis of fiscal space (Heller, 2005), is an essential reference for setting a government revenue target specific to a given country.

From then on, interest in this issue continued unabated.[6] The 2002 Monterrey Conference coincided with a renewal of the literature marked by the introduction of institutional and societal factors such as corruption and good governance.[7]

5 The term 'resource' should be understood as 'mining resources'. It pertains to non-renewable natural resources (minerals and hydrocarbons).

6 See Leuthold (1991), Tanzi (1992), Stotsky and WoldeMariam (1997), Ghura (1998), Piancastelli (2001) and Eltony (2002).

7 See Ghura (1998), Tanzi and Davoodi (2001), Bird *et al.* (2004), Davoodi and Grigorian (2007), Gupta (2007), Drummond *et al.* (2012) and Le *et al.* (2012).

1.2. Difficulties introduced by mining

Mining is the source of considerable public resources in a growing number of developing countries, and was treated in many studies in the 1970s as a factor with a highly positive impact on government revenue (Lotz and Morss, 1967; Bahl, 1971; Chelliah *et al.*, 1975; Tait *et al.*, 1979). However, until recently, the effect of mining on government revenue was only reflected by a dummy variable (Ghura, 1998; Davoodi and Grigorian, 2007), considered insignificant (Leuthold, 1991) or secondary (Gupta, 2007), or even ignored altogether (Piancastelli, 2001; Bird *et al.*, 2004; Le *et al.*, 2012). In addition, major oil and mining countries are generally under-represented in the sample countries selected.

For practitioners of tax policy, whilst tax potential estimates for non-mining or low-level mining countries appear to be a relevant factor in setting government revenue targets (for example, see the estimates for Morocco conducted by Brun *et al.*, 2009), the tax potential of countries with large mining industries cannot be credibly assessed if the impact of mining is not effectively taken into account.

The fact that many studies have shown little interest in the role of mining is all the more surprising given that, according to analyses of Dutch disease (Corden and Neary, 1982), the shocks engendered by non-renewable resources are likely to have a negative effect on tax revenues (Tanzi, 1982). Moreover, neglecting the influence of mining on government revenue appears paradoxical given that resource revenues have been rising sharply since the early 1990s (Crivelli and Gupta, 2014) and that a large proportion of non-renewable natural resources in African countries are yet to be discovered (Collier, 2006).

1.3. Mining as a determinant factor of government revenue

Following on from previous research, i.e. using total government revenue as the dependent variable, various studies undertaken since the late 1990s consider mining as an important factor in government revenue. However, this new wave of research stands out from earlier studies by systematically identifying a negative relationship between mining and tax revenues.

For instance, by introducing mining as an explanatory factor, Stotsky and WoldeMariam (1997) show a negative relationship between the contribution of mining to GDP and tax revenues, based on a sample of 46 countries in sub-Saharan Africa (over the period 1990-1995). A negative impact on tax revenues is also found by Eltony (2002), based on a sample of 16 Arab countries including major oil producers (for the period 1994-2000). For 28 low-income countries of sub-Saharan Africa (for the period 1990-2010), Drummond *et al.* (2012) confirm the negative impact of mining on tax revenues.

Rather than using total government revenue, 'innovative' studies take non-resource government revenue as a dependent variable and assess the effect of government revenue generated by mining (resource government revenue) on non-resource government revenue.

For instance, from a sample of 30 oil-producing countries (covering 1992-2005), Bornhorst *et al.* (2009) highlight the negative effect of mining revenue on non-resource government revenue. Ossowski and Gonzales (2012) obtain a

similar result for 15 Latin American countries (1994-2010), both exporters and non-exporters of mined products. From a large sample of sub-Saharan African countries, many of which have a significant mining industry, Thomas and Trevino (2013) also highlight the negative effect of government revenue from mining on non-resource government revenue. This observation is confirmed by Crivelli and Gupta (2014)[8] from a sample of 35 mining countries with varying levels of development.

1.4. Assessment of tax potential under a renewed concept of fiscal space

The 'innovative' studies, by considering non-resource government revenue specifically, profoundly amend the common concept of fiscal space (Heller, 2005) because they split government revenue into two components. The first – non-resource government revenue – excludes resource revenues and is endogenous. The second – resource government revenue – is largely exogenous, as it depends primarily on the existence of natural resources and on changes in the price of these resources which – except for large producers – are external to the country.

2. Resource and non-resource revenues: Stylised facts

Since the economic stagnation of the 1980s, total government revenue of all developing countries has grown steadily (up 4.1 percentage points of GDP since the early 1990s, Table 11.1). This growth derives partly from resource revenue, as the growth in non-resource tax revenues is only 2.2 percentage points of GDP over the same period (Table 11.2).

The upward trend is shared by all geographical regions except MENA (Middle East and North Africa) countries (Table 11.1). Asian countries have also seen an upward trend, but to a lesser extent. The observation of an upward trend is also true for non-resource tax revenues (Table 11.2).

An analysis by country group based on level of revenue (Table 11.1) shows a recovery of low-income countries (LICs) and lower middle-income countries (LMICs) during the 2000s (up 4.3 and 2.7 percentage points of GDP, respectively, from 1996 to 1998). The trend is similar for fragile states (up 3.9 percentage points of GDP from 1996 to 1998). The increase is more significant and steady for upper middle-income countries (up 8.4 percentage points of GDP from 1980 to 1982). Non-resource tax revenues have followed a similar trend.

8 These authors note a significant adverse effect: one additional point of resource tax revenues leads to a 0.43 point decline in non-resource revenues (both expressed in percent of GDP).

Table 11.1. *Total revenue: International trends and comparison (percent of GDP)*

	1980/1982	1988/1990	1996/1998	2003/2005	2010/2012
Developing countries	19.7 (72)	19.8 (86)	20.5 (106)	22.3 (116)	23.9 (101)
Sub-Saharan Africa	19.6 (41)	19.0 (43)	19.6 (44)	21.1 (45)	23.4 (44)
Latin America	17.5 (12)	18.8 (16)	19.1 (20)	21.8 (21)	23.1 (16)
East Asia and Pacific	16.8 (10)	18.7 (15)	19.7 (21)	19.2 (26)	19.7 (20)
MENA	26.5 (7)	22.8 (8)	27.2 (8)	26.8 (9)	25.6 (8)
LICs	16.6 (26)	14.8 (28)	13.5 (30)	14.0 (32)	17.8 (28)
Lower MICs	21.1 (24)	20.3 (30)	21.6 (39)	23.2 (41)	24.3 (39)
Upper MICs	21.9 (22)	24.3 (28)	25.1 (37)	27.6 (43)	28.3 (34)
Fragile states	17.5 (17)	16.2 (18)	15.2 (18)	16.5 (21)	19.1 (16)
WAEMU	18.1 (8)	16.0 (8)	14.5 (8)	15.7 (8)	20.0 (8)
CAEMU	22.0 (5)	15.8 (5)	17.8 (6)	21.5 (6)	30.3 (6)
Franc zone	19.6 (13)	15.9 (13)	15.9 (14)	18.2 (14)	26.9 (14)
Afr. non-Franc zone	19.6 (28)	23.3 (30)	21.4 (30)	22.4 (31)	22.9 (30)
Landlocked countries	17.9 (17)	19.6 (18)	20.7 (28)	23.3 (34)	26.7 (30)
COMESA	19.9 (16)	19.0 (17)	20.4 (18)	20.7 (18)	20.6 (17)

Notes: Sample size in parentheses. These data are weighted arithmetic averages calculated over three-year periods (1980-1982, 1988-1990, 1996-1998, 2003-2005, 2010-2012).
Source: Mansour (2014); Prichard *et al*., (2014); GFS (International Monetary Fund); national data and authors' calculations.

Table 11.2. *Non-resource tax revenues: International trends and comparison (percent of GDP)*

	1980/1982	1988/1990	1996/1998	2003/2005	2010/2012
Developing countries	14.2 (69)	13.9 (95)	14.3 (120)	15.3 (122)	16.1 (75)
Sub-Saharan Africa	13.4 (43)	12.4 (45)	12.6 (46)	14.1 (45)	15.3 (44)
Latin America	18.2 (8)	13.2 (19)	15.6 (26)	16.7 (25)	21.5 (7)
East Asia and Pacific	10.9 (14)	13.7 (22)	12.8 (25)	12.5 (26)	14.4 (17)
MENA	17.4 (5)	14.9 (7)	15.7 (8)	14.4 (10)	14.6 (4)
LICs	11.2 (26)	10.2 (29)	10.1 (31)	11.0 (31)	14.0 (27)
Lower MICs	14.9 (23)	14.1 (33)	14.1 (39)	14.5 (42)	15.6 (23)
Upper MICs	17.3 (20	17.1 (33)	17.0 (50)	18.7 (49)	19.0 (25)
Fragile states	13.1 (17)	11.7 (20)	10.6 (23)	10.8 (26)	13.7 (18)
WAEMU	13.8 (8)	10.8 (8)	11.2 (8)	13.0 (8)	14.1 (8)
CAEMU	12.3 (6)	10.4 (6)	8.5 (6)	7.8 (6)	8.5 (6)
Franc zone	13.2 (14)	10.6 (14)	10.0 (14)	10.8 (14)	11.7 (14)
Afr. non-Franc zone	13.5 (29)	13.2 (31)	13.7 (32)	15.6 (31)	17.0 (30)
Landlocked countries	14.2 (19)	13.9 (22)	16.4 (32)	17.2 (31)	16.9 (21)
COMESA	14.8 (13)	14.7 (15)	14.6 (17)	16.4 (17)	16.9 (17)

Notes: Sample size in parentheses. These data are weighted arithmetic averages calculated over three-year periods (1980-1982, 1988-1990, 1996-1998, 2003-2005, 2010-2012).
Source: Mansour (2014), ICTD (2014), GFS (International Monetary Fund), national data, and authors' calculations.

Amongst the countries of sub-Saharan Africa (Table 11.1), total revenues for the Franc zone countries declined sharply from 1980-1982, and from 1996-1998 (down 3.7 percentage points of GDP), which widened the gap with countries outside the Franc zone (15.9% compared to 21.4% of GDP in 1996-1998). A sharp increase was then experienced in the Franc zone countries, with the average ratio of government revenue to GDP reaching 26.9% in 2010-2012, compared with 22.9% for countries outside the Franc zone. Within the Franc zone, the relative position of CAEMU countries seems favourable, with an average ratio of government revenue to GDP of 30.3% in 2010-2012 compared to 20.0% for West African Economic and Monetary Union (WAEMU) countries. However, these developments are due solely to resource revenues, since the non-resource tax revenues of the Franc zone averaged only 11.7%, compared with 17% for countries outside the Franc zone. The average rate of non-resource tax revenues for CAEMU countries was particularly low in 2010-2012 (8.5% compared with 14.1% for WAEMU countries).

3. Method for assessing non-resource tax potential

3.1. Non-resource revenues as a dependent variable

The studies that use tax revenues as a dependent variable (Chelliah *et al.*, 1975; Ghura, 1998; Drummond *et al.*, 2012) exclude the share of resource revenues included in non-tax revenues. Tax revenues may therefore seem to be a proxy variable for non-resource revenues. However, a potentially significant share of tax revenues, for some countries at least, is levied on mining, particularly as corporate income tax. As such, using tax revenue alone as a dependent variable does not fix the problem of heterogeneity in the dependent variable. The recent availability of non-resource revenue statistics means that a homogeneous dependent variable can now be employed.

3.2. Method for assessing non-resource tax potential

3.2.1. Non-resource tax potential and tax effort

The objective here is to assess the non-resource tax potential independent of economic policy. As such, we use only structural factors, which are factors independent of economic policy, at least in the short term. In this way, we gain a measure of the relative impact of economic policy on the mobilisation of government resources (tax effort) from the relative difference between actual government revenue and tax potential.

Factors in non-resource tax potential

Resource government revenues, a factor of the tax potential. Resource government revenues – which are exogenous – can weaken the incentives to mobilise other sources of finance for public goods, particularly non-resource government revenue.[9]

Traditional factors in non-resource tax potential

GDP per capita. A high GDP per capita, indicative of a higher level of development and therefore a higher tax capacity, tends to strengthen government revenue levels (Farhadian-Lorie and Katz, 1989). In addition, demand for public goods increases with the level of development (Wagner's law), particularly because of social insurance requirements (Rodrik, 1998).

Trade openness ratio. Greater trade openness favours increased productivity and steadier growth (Frankel, 1999), and therefore greater mobilisation of government revenue. Taxes are also easier to levy at the border (Bornhorst *et al.*, 2009; Drummond *et al.*, 2012).

Agricultural value added in GDP. A large contribution of agriculture to GDP, particularly if it is subsistence agriculture (Gupta, 2007), is unfavourable to the mobilisation of government revenue. Furthermore, the demand for public goods is lower in most agricultural countries (Gupta, 2007).

4. Econometric results

The estimating equation can be written as follows:

$$\left(\frac{Tax^{NR}}{GDP}\right)_{it} = \alpha_i + \beta\left(\frac{TotR^{R}}{GDP}\right)_{it} + \theta controls_{it} + \varepsilon_{it}$$

Where:

$(Tax^{NR})_{it}$ = non-resource tax revenues of country i at time t; and

$(TotR^{R})_{it}$ = total resource revenues of country i at time t;

The panel data estimate (for the period 1980-2012) uses an unbalanced sample of 124 developing countries, for which data are available for the entire period or part thereof. Country-specific effects are introduced that pick up an unobserved heterogeneity specific to each country. The random effects estimator is used, as opposed to fixed effects, which assimilate the unobserved heterogeneity to structural factors; random effects assimilate only part of the unobserved heterogeneity to structural factors.

9 However, we cannot rule out that resource government revenues, by meeting the state's funding needs, are partly endogenous in nature (Crivelli and Gupta, 2014).

4.1. Estimated non-resource tax potential

The results are shown in Table 11.3. The parameters are all significantly different from zero. The signs of the coefficients are consistent with those expected, including that of the total resource revenues variable.

Table 11.3. *Econometric equation for determining the tax potential of developing countries (random effects)*

Dependent variable: Non-resource tax revenues/GDP			
Explanatory variables	Coefficients	Student's t	P-value
Constant	-3.044	1.41	0.158
Trade openness ratio (X+M)/GDP	0.011	2.76	0.006
Logarithm of lagged GDP per capita	2.752	10.0	0.000
Agricultural value added/GDP	-0.096	8.62	0.000
Total resource revenues/GDP	-0.136	9.14	0.000
R^2 = 0.30*	NT=2727 (Observations)	N=124 (Country)	

Note: * The R^2 does not include random effects.

4.2. Estimated non-resource tax effort

By choosing a large sample of developing countries, we can assess the relative tax effort of groups of countries categorised by geographic region or economic criteria (Table 11.3). By construction, as the mean of the residuals is zero, the tax effort should be interpreted relatively. The reference standard is provided by the average behaviour of the whole panel.

Table 11.4 provides an evaluation of tax effort for the period 1980-2012. It shows a declining tax effort for sub-Saharan African countries until the early 2000s. Economic policy measures introduced from the early 1990s have improved the mobilisation of tax revenues, which (for the period 2010-2012) was 2.6 percentage points of GDP higher than the tax potential. Latin American and Asian countries are characterised by a consistently negative tax effort. However, the effort appears to rise for Latin American countries, whereas it falls for Asian countries. These results accentuate the extent of tax efforts estimated by Le *et al.* (2012) that, by considering tax revenues as a dependent variable, partially eliminate the resource component (see above). An estimated strongly positive non-resource tax effort for sub-Saharan African countries belies common wisdom. This could be explained by the pertinence of tax reforms that concerned both tax legislation (particularly VAT) and administration. The delay in tariff liberalisation may also be a part of the explanation, by providing states with a source of revenue that is easier to collect.[10]

10 For the period 2003-2012, the standard deviation for the tax effort is higher in sub-Saharan Africa (5.8) than in Latin America (4.5) and East Asia and the Pacific (3.8). The situations within Africa are more varied. Note that the standard deviation of WAEMU member countries is only 1.1 compared with 3.3 for CAEMU countries and 6.3 outside the Franc zone.

Table 11.4. *Tax effort, non-resource tax revenues: International trends and comparison (percent of GDP)*

	1980/1982	1988/1990	1996/1998	2003/2005	2010/2012
Developing countries	1.0 (43)	0.4 (69)	0.0 (106)	-0.5 (118)	1.4 (99)
Sub-Saharan Africa	1.7 (30)	0.7 (41)	0.5 (43)	1.3 (44)	2.6 (42)
Latin America	-4.1 (3)	-3.4 (9)	-3.3 (21)	-2.5 (24)	-2.1 (19)
East Asia and Pacific	-0.4 (7)	-1.7 (11)	-1.0 (19)	-3.1 (23)	-2.2 (20)
MENA	1.2 (4)	0.6 (7)	-0.5 (9)	-2.0 (9)	1.3 (6)
LICs	2.3 (18)	0.8 (25)	1.3 (28)	1.0 (29)	2.8 (26)
Lower MICs	2.3 (14)	0.2 (19)	1.3 (35)	-0.4 (41)	1.6 (34)
Upper MICs	-2.9 (11)	0.1 (25)	-1.2 (43)	-1.5 (48)	0.3 (39)
Fragile States	3.3 (12)	1.0 (15)	-0.2 (18)	-0.5 (21)	2.2 (16)
WAEMU	2.3 (8)	1.0 (8)	-0.4 (8)	1.8 (7)	3.1 (7)
CAEMU	-3.6 (4)	-4.4 (5)	-5.1 (5)	-3.9 (5)	-3.9 (5)
Franc zone	0.4 (12)	-1.1 (13)	-2.2 (13)	-0.6 (12)	0.5 (11)
Afr non-Franc zone	2.5 (18)	1.5 (28)	1.7 (30)	2.0 (32)	3.4 (31)
Landlocked countries	3.0 (13)	2.0 (19)	2.8 (28)	1.7 (29)	4.5 (27)
COMESA	4.0 (12)	2.9 (16)	3.0 (18)	2.8 (17)	3.1 (15)

Notes: Sample size in parentheses. These data are weighted arithmetic averages calculated over three-year periods (1980-1982, 1988-1990, 1996-1998, 2003-2005, 2010-2012).
Source: Mansour (2014), ICTD (2014), GFS (International Monetary Fund), national data and authors' calculations.

The performance of the LICs deteriorated up until the mid-2000s, but has recovered in recent years. The tax effort of middle-income countries appears lower. The effectiveness of upper middle-income countries' economic policy is close to the norm. The two components of the Franc zone show opposite results. The WAEMU countries, where mining resources have a limited role, were able to mobilise beyond their potential and achieve a performance similar to that of the Common Market for Eastern and Southern Africa (COMESA) region. CAEMU countries, which are more dependent on resources, do not fully exploit their potential. Fragile states and landlocked countries mobilise revenue beyond their potential; we cannot rule out that this may result from tax policies designed to overcome countries' disadvantages.

Conclusion

The new measure of developing countries' non-resource tax effort proposed here profoundly alters the diagnosis for mobilising government revenue of developing countries and their need for additional funding to finance public expenditures.

According to the results, the countries of Latin America and Asia, characterised by a negative average tax effort, do not fully exploit their tax revenue potential. Their tax revenues could be increased if they made it a priority to adopt a more effective tax mobilisation policy. A first step could be to achieve the average effectiveness of tax mobilisation policies in the sample countries (zero tax effort).

In contrast, on average, other groups of countries (low-income countries, fragile states, sub-Saharan African countries and WAEMU member countries) have implemented a more effective tax revenue mobilisation policy than the sample average and thereby fully exploit their tax potential. With such a positive tax effort, to avoid the detrimental effect of growing tax distortions, which increase with the size of the tax effort, it is essential that the effectiveness of public spending offset the social cost generated by taxation. Therefore, to complement an improved tax mobilisation policy, the negative impact of taxation should be reduced by improving its economic neutrality. Finally, states can also use other types of external or internal funding to finance public expenditure in accordance with the need for public goods.

For countries largely dependent on mining, such as CAEMU member countries, their highly negative tax effort leads to a poor mobilisation of non-resource tax revenues. These countries make up the shortfall with tax revenues from mining. Although this allows them to reduce the tax burden on their populations, these countries are losing an opportunity to expand their fiscal space, whilst at the same time accepting the risk entailed by the relative instability of their resources. In addition, the development of Dutch disease driven by the intensive use of revenues from mining can negatively affect other tradable sector tax bases, therefore leading to a further reduction in the domestic tax effort.

Finally, in addition to regional findings based on averages, the great diversity of situations makes it essential to determine a tax effort strategy for each country. Determining an optimum public tax structure by country requires a fiscal space approach, of which the mobilisation of revenue is one component. Given the crucial importance of an adequate supply of public goods to promote development, a positive tax effort should in most cases encourage countries to improve the neutrality of taxation and the effectiveness of public expenditure, rather than encouraging them to relax their tax mobilisation efforts. Choosing to relax their efforts would be even riskier, given that the performance of fragile states and African countries remains unpredictable, as it can be challenged by the frequent exogenous shocks that affect these countries.

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12

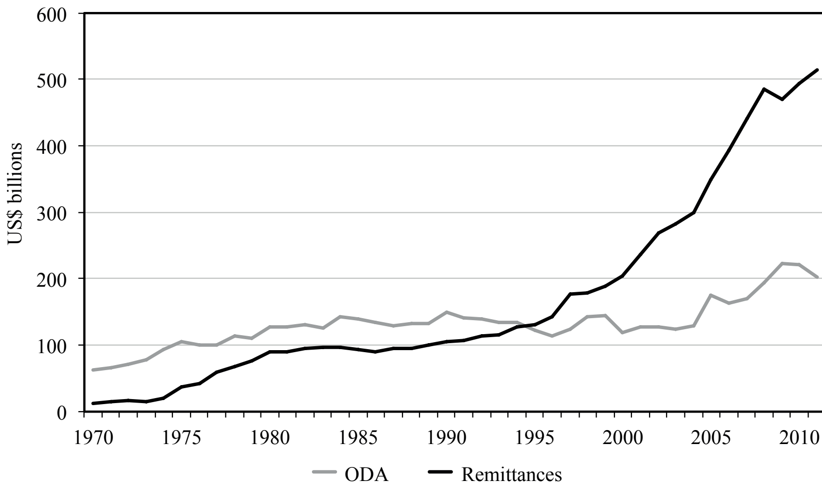
Remittance and Migration Prospects for the Twenty-First Century[1]

Frédéric Docquier and Joël Machado[2]

1. Introduction

Foreign aid and remittances (i.e. transfers of money by international migrants to their home country) are key sources of external resources for developing countries. In particular, remittances have been increasingly perceived as offering a vital lifeline for millions of poor households in developing countries and their levels have kept rising over the last decades. Figure 12.1 depicts the evolution of the worldwide amounts of recorded remittances and foreign aid from 1970 to 2011.

Figure 12.1. *Remittances and official development assistance, 1970-2011*



In the early 1970s, the amount of official aid (US$62.2 billion) far exceeded that of remittances (US$12.4 billion). Forty years later, worldwide remittances were equal to US$514 billion, about 2.5 times greater than foreign aid. Overall, the

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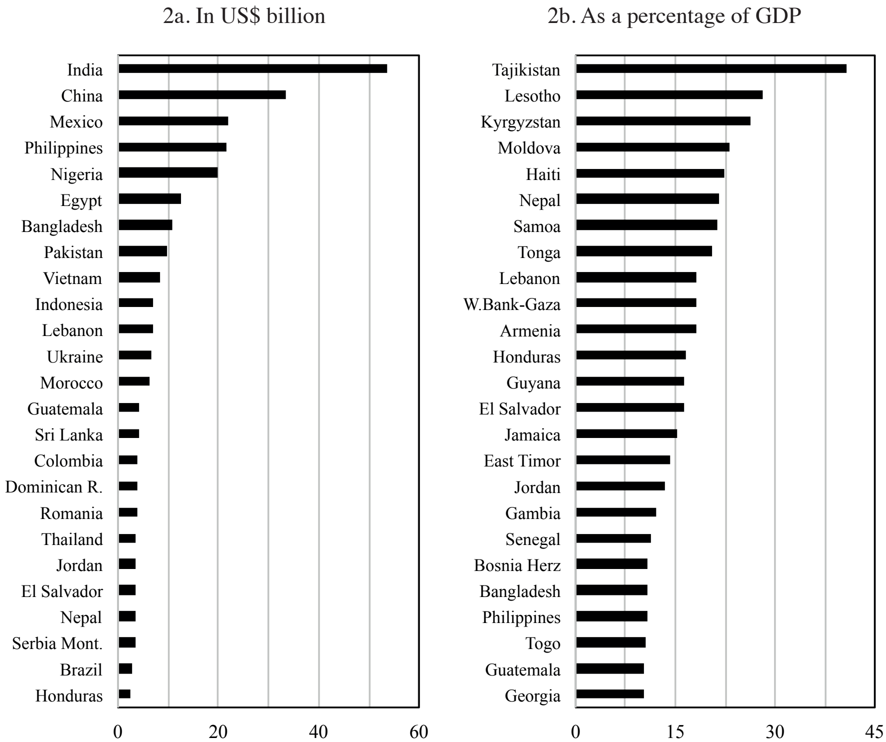
amount of official development aid to developing countries has increased by about 2.9% per year since 1970, while the average annual growth rate of international remittances has been 9.5%. Recorded remittances have more than doubled over the last ten years, and the financial crisis of the last decade hardly affected this trend. These numbers are estimates based on recorded flows and are thus likely to underestimate the full scale of remittances.

About 70% of the worldwide total of remittances is sent to developing countries. Many developing countries receive more financial support from their own migrants than from the international community. There are, however, huge disparities between income groups: the amount of recorded remittances is five to seven times greater than foreign aid in middle-income countries, but it represents only 60% of foreign aid in low-income countries. Figure 12.2 identifies the main recipient countries in 2010 (after excluding high-income countries).

Figure 12.2. *Main recipient countries, 2010*



In Figure 12.2a, countries are ranked on the basis of the aggregate monetary amount received. The two most populous countries in the world, India and China, are the main recipients. In 2010, Indian and Chinese expatriates sent US$53.5 billion and US$33.4 billion, respectively, to their home countries. Next in the ranking are Mexico, the Philippines, Nigeria, Egypt, Bangladesh, Pakistan, Vietnam and Indonesia. In Figure 12.2b, the ranking is based on remittances as

a percentage of GDP. In relative terms, the main recipients are low-income former Soviet states (Tajikistan, Kyrgyzstan and Moldova), Middle East countries (Lebanon, West Bank and Gaza) and other small poor countries such as Lesotho, Haiti, Nepal, Samoa, Tonga, and Guyana. Remittances as a percentage of GDP exceed 15% in 15 countries, and reach 40% in Tajikistan.

Remittance patterns are obviously affected by the evolution of emigration stocks and cross-country disparities in income. Indeed, the number of international migrants increased from 92 to 211 million between 1960 and 2010. In addition, data by education level indicate that emigration rates are greater in middle-income countries than in the poorest countries of the world. This might be due to financial constraints and partly explains why low-income countries receive less in remittances than the middle-income countries. Nevertheless, the evolution of international migration alone cannot explain the extraordinary shift in the level of remittances. Since 1970, the number of international migrants has increased by 1.65% per year; this is much smaller than the growth rate of remittances. Hence, the average amount sent by each migrant increased from US$118 per year in 1970 to US$2,583 in 2011. Several factors can explain this drastic change, including rising income disparities between high-income and developing countries, the changing composition of migration, lower transaction costs, and a greater proportion of remittances being recorded in the balance of payment.

While the amount of foreign aid has grown at a relatively stable rate in the past, the dynamics of remittances are more difficult to predict. First, the evolution of remittances will be affected by the future of international migration. Since World War II, the number of international migrants has grown at a similar pace to the world population: the worldwide average migration rate has been fairly stable at around 3% of the world population. However, the proportion of foreign-born in the populations of high-income OECD countries has increased from 4.6% to 10.9%, and the share of immigrants originating from developing countries has soared from 1.5% to 8.0%. Immigration has become a key policy issue in traditional high-income countries, and restrictions could get tougher in the future. Second, some emerging countries have taken off and have partly caught up with high-income countries since the late 1980s. The long-run development prospects in China, India and other emerging countries, coupled with the evolution of their immigration policies, will shape the size and structure of migration flows. Third, the dynamics of remittances will also be affected by the demographic and economic disparities between regions. These disparities will govern the evolution of income inequality as well as the incentives to emigrate (i.e. the ratio of emigrants to stayers in recipient countries). For example, the macroeconomic and demographic prospects for sub-Saharan African countries are key determinants of future migration flows. The share of this continent in the world population is expected to increase threefold in the course of the twenty-first century.

In this chapter, we provide projections of migration and remittances for the twenty-first century under alternative technological, socio-demographic and

migration policy scenarios. To do so, we use a dynamic model of the world economy with endogenous income disparities, migration, fertility and education decisions. The model accounts for the links between skills-biased emigration prospects, investment in human capital and population growth. Using scenarios for the evolution of total factor productivity (TFP), education policies and immigration barriers, we jointly predict the evolution of income inequality, population growth, migration flows and remittances. Then, using scenarios for the evolution of the propensity to remit, we predict the ratio of remittances to GDP in developing regions. We show that remittances will be a sustainable source of funding for developing countries. Due to rising income disparities and the emergence of new flourishing destination countries, the share of remittances in GDP is likely to increase in the future, notwithstanding the fact that population growth will be greater in low-income countries. The average ratio of remittances to GDP could be multiplied by a factor of between two and six in low-income countries in our most plausible scenarios.

2. The framework

Our analysis is based on a projection model that covers the world economy over the period 2000-2100. The model endogenises the evolution of income and population in 195 countries, as well as bilateral migration stocks by education level. We use the model to predict the evolution of emigration rates and the aggregated income of emigrants and stayers under alternative scenarios.

A full description of the model and its calibration can be found in our forthcoming Ferdi working paper under the same title. The main ingredients are the following. At each period of time, the world population is made up of adults – the only decision-makers – and their children. Adults are heterogeneous in terms of country of birth, ability to acquire higher education and migration taste. They decide whether to acquire higher education or not before discovering their migration taste. They participate in education if the expected benefits from a college education exceed the training effort; adults who did not receive basic education have no access to higher education. The expected benefit from a college education is affected by emigration prospects: if migration restrictions are skills-biased, individuals anticipate that acquiring a higher education increases the probability of migrating to a wealthier country. This cost-benefit analysis determines the number of college-educated and less-educated natives. Then, natives discover their migration taste and decide whether to emigrate or to stay in their home country. This determines the number of college-educated and less-educated residents. Finally, after migration, each adult chooses the number of children and the proportion of these who receive a basic education.

The structure of the resident labour force and fertility decisions determines the supply of labour in each country. In turn, this determines the equilibrium wage rates and the level of GDP. In this general equilibrium framework, decisions about fertility, education, migration and the world distribution of income (i.e. wage disparities across and within countries) are therefore interdependent.

We simulate our model under seven scenarios:

1. The '*Baseline*' scenario assumes that (i) the average TFP level of the BRICs (Brazil, Russia, India and China) will increase from 30.4% to 87.7% of the US level, and the average TFP level of sub-Saharan African countries will decrease from 23.6% to 15.6% of the US level; (ii) the world population aged 25 and over will increase from 3.2 billion to 10.4 billion (as in the 'High Fertility' variant of the United Nations population prospects) and the share of college graduates will increase from 11.2% to 14.3% between 2000 and 2100; and (iii) migration costs will remain constant over the twenty-first century (i.e. constant moving costs and migration policies).
2. The '*Slower BRIC*' variant assumes a slower convergence for the BRICs. On average, the average TFP of the BRICs will increase from 30.4% to 47.5% of the US level between 2000 and 2100 (compared with the 87.7% in the baseline).
3. The '*Faster SSA*' variant assumes a faster convergence for sub-Saharan African countries. While diverging in the baseline scenario, under this scenario the relative TFP level of sub-Saharan countries will partly converge towards the US level: on average, the average TFP of African countries will increase from 23.6% to 28.9% of the US level between 2000 and 2100 (compared with 15.6% in the baseline). Hence, TFP in Africa will grow more rapidly than in rich countries under this scenario.
4. The '*Low FERT*' variant assumes lower birth rates in all the countries of the world. Compared to the baseline, we reduce children's potential income by 16.7% in all countries from 2025 onwards. This reduces the opportunity cost of a basic education and the fertility rate. The effect is stronger in poor countries where child labour is most prevalent.
5. The '*High EDUC*' variant assumes greater educational attainment in all the countries of the world. Compared to the baseline, we reduce the cost of basic education by 33.3% in all countries from 2025 onwards. Hence, the investment in a basic education by low-skilled parents and the pool of adults eligible for higher education will gradually increase over the course of the twenty-first century.
6. The '*Restr USA*' variant assumes greater immigration restrictions in the United States. Basically, this implies that the long-run immigration rate of the United States will fall from 12.5% to 5.2%.
7. In the '*Open CHIND*' variant, the costs of migrating to China and India will fall from 2025 onwards. We assume that China and India will become as attractive as the United States.

We consider the latter two scenarios as less plausible than the others. However, they illustrate well the effects of migration restrictions on future migration flows and remittances.

3. World economy prospects

Figure 12.3 describes the evolution of the world economy under these seven macroeconomic variants. The left panel represents the trajectory of each variable over the twenty-first century, along with historical data for the nineteenth and twentieth centuries. For each alternative scenario, the right panel gives the percentage of deviation from the baseline over the twenty-first century. Table 12.1 presents the long-run population, income and migration projections for selected regions.

Figure 12.3. *Demographic and economic projections for the world economy, 2000-2100*

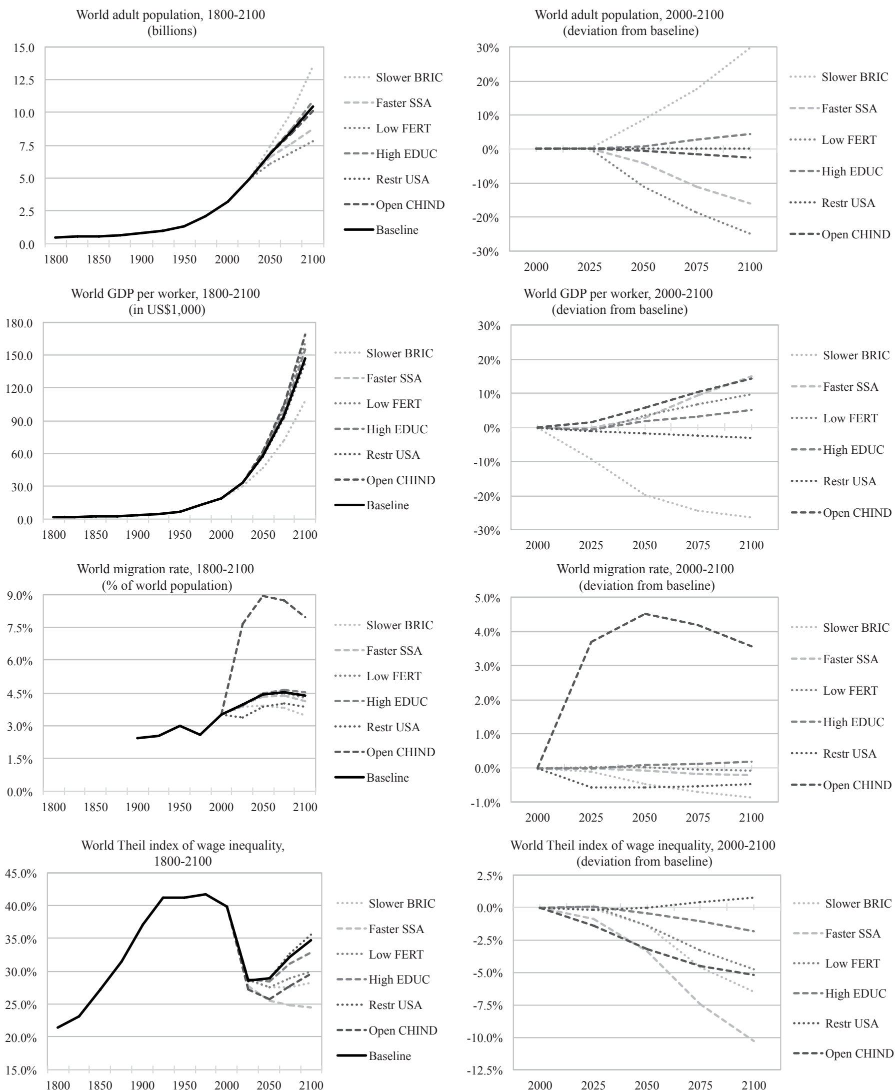


Table 12.1. *Projections by region and scenario, 2100*

	Obs.	Base	Slower BRIC	Faster SSA	Low FERT	High EDUC	Restr USA	Open CHIND
	2000	2100	2100	2100	2100	2100	2100	2100
				Share in the world population aged 25 and over				
USA	5.8	6.0	4.7	7.1	7.7	6.9	3.9	5.9
EU15	8.4	5.6	4.3	6.2	6.4	6.1	5.7	5.4
MENA	4.2	6.1	4.7	7.1	5.7	5.8	6.3	4.5
SSA	7.1	20.4	15.7	5.9	15.3	19.4	20.6	20.8
CHIND	39.0	32.1	42.8	38.2	33.4	30.7	32.1	41.9
				Share in world aggregate income				
USA	21.2	12.5	13.7	12.6	14.3	13.6	8.4	10.6
EU15	19.5	10.7	11.7	10.3	11.1	11.3	11.3	9.0
MENA	3.2	2.5	2.7	2.5	2.2	2.4	2.7	1.6
SSA	2.3	3.4	3.7	1.9	2.4	3.2	3.5	3.0
CHIND	17.1	45.7	41.7	47.0	44.3	42.3	47.1	57.2
				Proportion of immigrants				
USA	13.2	12.5	13.0	11.6	10.5	12.0	5.2	10.9
EU15	7.5	17.2	17.7	14.2	14.4	16.0	17.2	15.4
CHIND	0.4	2.1	0.9	2.0	1.9	2.1	2.1	11.2
				Emigration rate of college graduates				
MENA	17.5	25.2	25.1	25.3	25.5	25.3	21.7	41.0
SSA	15.8	26.8	26.7	18.1	26.9	27.8	23.0	28.5
CHIND	5.7	1.4	2.5	1.4	1.5	1.5	0.9	12.8

Figures 3a and 3b describe the evolution of the world population. In the baseline, the world population aged 25 and over will increase from 3.2 billion to 10.4 billion between 2000 and 2100. This implies an average annual growth rate of 1.2%. As shown in Table 12.1, the share of Africa in the world adult population will increase from 7.1% in 2000 to 20.4% in 2100. The shares of the EU15, China and India will fall. Three factors drastically affect the evolution of the world population. Under the 'Slower BRIC' scenario, the wage rate (i.e. the opportunity cost of education) increases less rapidly in emerging countries. Under this scenario, the share of China and India in the world population keeps on increasing over the course of the twenty-first century (see Table 12.1). Compared to the baseline, the fertility rate is greater and by 2100 the world population will be 29.9% larger, reaching 13.5 billion (compared with 10.4 billion under the baseline). This roughly corresponds to the United Nations population projection with constant fertility. In contrast, under the 'Faster SSA' scenario, fertility decreases in Africa and the world population will be 16.2% smaller in 2100 (8.7 billion instead of 10.4 billion under the baseline); the share of Africa in the world adult population will reach 15.7% in 2100 (rather than 20.4% in the baseline). The latter population trajectory is similar to the medium-fertility variant of the United Nations projections. Similarly, the world population aged 25 and over will be 25% lower than in the baseline (10.4 billion) in the 'Low FERT' scenario. It will reach 7.8 billion in 2100, which roughly corresponds to the central variant of the United Nations projections.

Figures 3c and 3d describe the evolution of GDP per worker. In the baseline, the worldwide average income increases from US$18,500 to 147,300 between 2000 and 2100, which amounts to an average annual growth rate of 2.1%. These income prospects are drastically affected by TFP in Africa and in China and India. The share of the latter two countries in the world aggregate income increases from 17.1% to 45.7% over the twenty-first century. The long-run level of income per worker is 26.5% lower under the 'Slower BRIC' variant, and 14.5% greater under the 'Faster SSA' variant. In addition, income per worker will drastically increase if emerging countries open their borders to immigration (+14.5% under the 'Open CHIND' variant).

Figures 3e and 3f describe the evolution of the Theil index of wage inequality. Since the beginning of the nineteenth century, the world distribution of income has become more unequal: the level of the Theil index has increased from 0.45 to 0.80, and its across-country component has risen from 0.08 to 0.50. Our model disregards within-group inequality and only captures inequality between countries and between skill levels. Our Theil index reaches 0.398 in 2000, which corresponds to 50% of the actual Theil index. In the baseline, the Theil index will decrease between 2000 and 2050 (from 0.398 to 0.289) and slightly increase between 2050 and 2100 (from 0.289 to 0.347). Four factors drastically affect the evolution of income inequality. Under the 'Faster SSA' scenario, the long-run level of the Theil index will be 10% lower; under the 'Low FERT', 'Slower BRIC' and 'Open CHIND' variants, it will be 4-6% lower.

Finally, Figures 3g and 3h describe the evolution of the world migration rate. Assuming unchanged immigration policies, the worldwide average proportion of adult migrants will increase from 3.5% to 4.5% over the twenty-first century. This rate is stable across scenarios; it could be 0.5 percentage points lower if the US immigration policy were to become more restrictive, and about 1.0 percentage point lower under the 'Low FERT' variant. The only scenario inducing a large change in the world migration rate is the 'Open CHIND' one. If income in China and India were to converge towards the US level and if these countries were to open their borders to immigration, the world migration rate would be twice as large in the long run, an extraordinary shift compared to historical data.

The evolution of the worldwide average migration rate hides large differences between destination regions. Migrants tend to agglomerate in high-income countries, as shown in Table 12.1. In the baseline, a moderate decrease in immigration rates will be observed in the United States, Japan, Switzerland, South Africa, Canada and Australia. In contrast, European and emerging countries will see their immigration rates increase. In the EU15, the immigration rate will be 2.3 times larger in 2100 than in 2000, due to a combination of two factors. On the demand side, Europe will gradually become more attractive, due to convergence in TFP and income with the United States. More importantly, on the supply side, rising income disparities with sub-Saharan Africa and the MENA (Middle East and Northern Africa) region will increase the pressure to migrate to Europe. Under the 'Faster SSA' scenario, the immigration rate could be reduced by 3 percentage points in Europe (from 17.7% to 14.2%). A similar decrease in immigration rate is obtained in the 'Low FERT' scenario (from 17.7% to 14.4%). TFP and the population growth rates in Africa are thus key determinants of the pressure to migrate to Europe. In all of the scenarios, the brain drain from Africa and the MENA region is expected to increase during the twenty-first century, but it will be smaller in China and India, due to income convergence (see Table 12.1).

4. Remittance prospects for the twenty-first century

We now use the world economy prospects to simulate the evolution of the ratio of remittances to domestic GDP in developing countries. To do so, we calibrate the propensity to remit of each country to perfectly match data on the remittances-to-GDP ratio in 2000. We consider two scenarios for the evolution of the propensity to remit: the first (optimistic) one assumes a constant propensity to remit, and the second (pessimistic) one assumes a -0.5 elasticity of the propensity to remit to the emigrant-to-stayer ratio. Hence, under a constant propensity to remit, the ratio of remittances to GDP is proportional to the ratio of the aggregate income between emigrants and residents, i.e. an elasticity of remittances to the stock of emigrants equal to unity. The second scenario implies an elasticity of remittances to the stock of emigrants equal to 0.5. Some previous empirical analyses of the determinants of remittances have used the amount of remittances per migrant as a dependent variable. They disregarded the role of the number of emigrants or implicitly assumed that remittances are proportional to emigration, as in our

first scenario. Other studies have included the number of emigrants in the set of regressors, and found an elasticity of remittances to the stock of emigrants ranging from 0.5 to 1.0, somewhere between our first and second scenarios.

Constant propensity to remit

Results for developing regions obtained with a constant propensity to remit are depicted in Table 12.2a. The ratio of remittances to GDP will drastically increase under all macroeconomic scenarios. Under the baseline world economy prospects, it will increase from 2.2% to 12.6% in low-income countries, and from 2.5% to 8.0% in the least developed countries. These ratios are of the same order of magnitude as the current ratios observed in the 20 main recipient countries. On average, this ratio will be multiplied by between 2 and 2.5 in all developing regions except in Latin America and the Caribbean, where it stagnates. Unreported country-specific results show that remittances will gradually become a negligible resource for emerging economies such as China and India. In contrast, if the propensity to remit remains constant, the ratio of remittances to GDP will soar in large recipient countries such as Tajikistan, Nepal, Bangladesh, the Philippines, Jordan, Morocco, El Salvador, Guatemala or even Mexico.

The comparison of macroeconomic scenarios reveals that the ratio of remittances to GDP will increase less if emerging countries grow slower (due to a decrease in emigration to emerging countries and in emigrants' income) or if Africa takes off (due to a decrease in the willingness to emigrate from Africa). A fall in fertility and population growth would also reduce the demographic share of developing countries, the number of emigrants and the amount of remittances. In contrast, if the convergence of emerging countries is accompanied by a relaxation of immigration restrictions, the long-run ratio of of remittances to GDP would reach 16.5% in low-income countries and 11.5% in the least developed countries. Drastic changes would be observed in the MENA and Asian countries.

Declining propensity to remit

As discussed above, many empirical studies on the determinants of remittances have found an elasticity of remittances to emigration of below one. Table 12.2b gives the evolution of the remittances-to-GDP ratio under a declining propensity to remit, i.e. assuming a -0.5 elasticity of the propensity to remit to the emigrant-to-stayer ratio.

The ratio of remittances to GDP is expected to increase from 2.2 to 5.4 in low-income and from 2.5 to 3.8 in least developed countries. Under the baseline world economy prospects, the long-run level of the remittances-to-GDP ratio would reach 125.4% in Tajikistan, 51% in Nepal, 48.6% in Bangladesh, 36.4% in Haiti and 35.4% in Kyrgyzstan. Greater levels are reached in the optimistic 'Open CHIND' macroeconomic scenario.

Table 12.2. *Projections of remittances as percentage of GDP, 2000-2100*
2a. Assuming a constant propensity to remit

	Baseline	Slower BRIC	Faster SSA	Low FERT	High EDUC	Restr USA	Open CHIND
LOW = Low-income countries (World Bank classification)							
2000	2.2	2.2	2.2	2.2	2.2	2.2	2.2
2025	7.5	5.5	7.4	7.7	7.3	7.2	14.6
2050	14.1	8.7	13.3	12.6	14.4	13.7	28.1
2075	14.2	8.9	12.2	11.3	14.7	13.8	23.8
2100	12.6	8.7	9.3	8.7	13.6	12.2	16.5
LDC = Least developed countries (United Nations classification)							
2000	2.5	2.5	2.5	2.5	2.5	2.5	2.5
2025	6.3	4.7	6.3	6.5	6.2	6.1	12.8
2050	10.4	6.4	10.1	9.3	10.6	10.2	22.1
2075	9.9	6.0	9.2	7.9	10.2	9.8	18.1
2100	8.0	5.2	6.9	5.7	8.4	7.9	11.5
SIDS = Small Island Developing States (United Nations classification)							
2000	2.0	2.0	2.0	2.0	2.0	2.0	2.0
2025	2.9	2.8	2.8	2.9	2.8	2.1	2.9
2050	3.5	3.4	3.2	3.2	3.7	2.8	3.5
2075	3.7	3.7	3.1	3.0	4.1	3.2	3.8
2100	3.4	3.4	2.7	2.4	3.7	3.1	3.5
Asia (except China, India, GCC and MENA countries)							
2000	0.8	0.8	0.8	0.8	0.8	0.8	0.8
2025	1.3	1.1	1.3	1.3	1.2	1.1	3.1
2050	2.0	1.5	2.0	1.9	2.1	1.9	6.2
2075	2.4	1.7	2.4	2.0	2.6	2.3	7.5
2100	2.4	1.7	2.4	1.8	2.6	2.2	6.9
MENA = Middle East and Northern Africa							
2000	2.1	2.1	2.1	2.1	2.1	2.1	2.1
2025	2.9	2.9	2.9	2.9	2.8	2.7	3.3
2050	3.5	3.5	3.5	3.2	3.7	3.3	4.7
2075	4.0	4.0	4.0	3.3	4.3	3.8	5.7
2100	4.1	4.1	4.1	3.1	4.5	3.9	5.9
SSA = sub-Saharan Africa							
2000	1.0	1.0	1.0	1.0	1.0	1.0	1.0
2025	1.4	1.4	1.3	1.5	1.4	1.3	1.4
2050	1.8	1.7	1.1	1.6	1.9	1.6	1.8
2075	1.9	1.9	0.7	1.4	2.1	1.8	2.0
2100	2.2	2.1	0.5	1.3	2.5	2.0	2.3
LAC = Latin America and the Caribbean							

	Baseline	Slower BRIC	Faster SSA	Low FERT	High EDUC	Restr USA	Open CHIND
2000	0.9	0.9	0.9	0.9	0.9	0.9	0.9
2025	1.1	1.1	1.1	1.1	1.1	0.7	1.1
2050	1.1	1.2	1.1	1.0	1.2	0.8	1.1
2075	1.1	1.3	1.1	0.9	1.2	0.8	1.1
2100	1.0	1.3	1.0	0.8	1.1	0.8	1.0

2b. Assuming a -0.5 elasticity of the propensity to remit to the emigrant-to-stayer ratio

	Baseline	Slower BRIC	Faster SSA	Low FERT	High EDUC	Restr USA	Open CHIND
LOW = Low-income countries (World Bank classification)							
2000	2.2	2.2	2.2	2.2	2.2	2.2	2.2
2025	4.8	3.6	4.8	5.0	4.7	4.6	9.5
2050	6.9	4.5	6.4	6.2	7.1	6.7	13.9
2075	6.3	4.3	4.9	4.9	6.6	6.1	10.3
2100	5.4	4.1	3.4	3.7	6.0	5.2	7.0
LDC = Least developed countries (United Nations classification)							
2000	2.5	2.5	2.5	2.5	2.5	2.5	2.5
2025	4.3	3.4	4.3	4.5	4.2	4.1	8.8
2050	5.4	3.7	5.2	4.8	5.6	5.3	11.7
2075	4.7	3.2	4.1	3.7	4.8	4.6	8.7
2100	3.8	2.8	2.9	2.6	4.1	3.7	5.7
SIDS = Small Island Developing States (United Nations classification)							
2000	2.0	2.0	2.0	2.0	2.0	2.0	2.0
2025	2.4	2.4	2.4	2.5	2.4	1.8	2.4
2050	2.6	2.6	2.4	2.4	2.8	2.0	2.6
2075	2.5	2.5	2.2	2.0	2.7	2.1	2.5
2100	2.2	2.1	1.8	1.6	2.3	2.0	2.2
Asia (except China, India, GCC and MENA countries)							
2000	0.8	0.8	0.8	0.8	0.8	0.8	0.8
2025	1.0	0.9	1.0	1.1	1.0	0.9	2.6
2050	1.3	1.0	1.3	1.2	1.4	1.2	4.5
2075	1.4	1.1	1.4	1.2	1.5	1.3	5.2
2100	1.4	1.1	1.4	1.1	1.5	1.2	4.9
MENA = Middle East and Northern Africa							
2000	2.1	2.1	2.1	2.1	2.1	2.1	2.1
2025	2.6	2.6	2.6	2.6	2.5	2.4	3.0
2050	2.9	2.9	2.9	2.6	3.0	2.7	3.9
2075	3.1	3.1	3.1	2.5	3.3	2.9	4.5
2100	3.1	3.1	3.1	2.3	3.4	3.0	4.6
SSA = sub-Saharan Africa							

	Baseline	Slower BRIC	Faster SSA	Low FERT	High EDUC	Restr USA	Open CHIND
2000	1.0	1.0	1.0	1.0	1.0	1.0	1.0
2025	1.3	1.3	1.2	1.4	1.3	1.2	1.3
2050	1.5	1.5	1.0	1.3	1.6	1.3	1.5
2075	1.5	1.5	0.6	1.1	1.7	1.4	1.6
2100	1.6	1.6	0.3	1.0	1.9	1.4	1.7
LAC = Latin America and the Caribbean							
2000	0.9	0.9	0.9	0.9	0.9	0.9	0.9
2025	1.0	1.0	1.0	1.0	0.9	0.6	1.0
2050	0.9	1.0	0.9	0.9	1.0	0.6	0.9
2075	0.8	1.0	0.8	0.7	0.9	0.6	0.8
2100	0.8	1.0	0.8	0.6	0.8	0.6	0.8

5. Conclusion

Remittances have substantially increased over the last decades, offering a vital lifeline for millions of poor households in developing countries. Their future development will be affected by the evolution of emigration rates and cross-country disparities in income. In this chapter, we present integrated projections of income, population, migration stocks and remittances for the twenty-first century under alternative technological and policy scenarios. Our quantitative analysis reveals that remittances will remain a major source of funding for low-income countries.

Figure 12.4. *Remittances as percentage of GDP in low-income countries (2000-2100)*

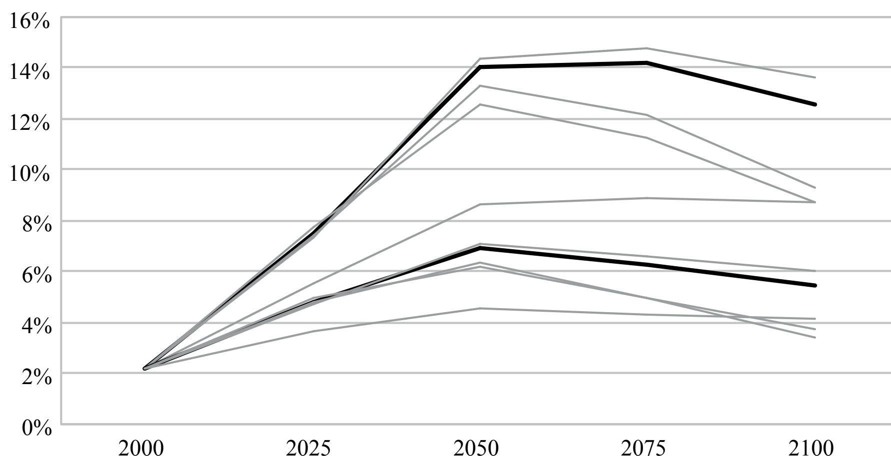


Figure 12.4 summarises the projections obtained under our ten most plausible scenarios (i.e. five non-extreme macroeconomic variants of the prospects for the world economy, multiplied by two scenarios for the propensity to remit) for low-income countries. Bold lines represent the two scenarios involving baseline macroeconomic prospects and constant versus declining propensities to remit. Thin lines represent the alternative technological and socio-demographic scenarios. The figure confirms that remittances will be a sustainable source of funding for developing countries. In the worst-case scenario, remittances as a percentage of GDP will double over the course of twenty-first century. Due to rising income disparities and the take-off of emerging countries, the importance of remittances is likely to increase in the future, notwithstanding the fact that population growth will be greater in low-income countries. In our most plausible scenario, the average ratio of remittances to GDP will be multiplied by a factor of between two and six in low-income countries. More than ever before, remittances are likely to become a revitalising resource for poor countries in the twenty-first century.

References

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13

A New Instrument Supporting Regional Integration in Africa

Patrick Guillaumont and Sylviane Guillaumont Jeanneney[1]

Introduction

Because of the small size of most African countries in terms of both their populations and their economies, the great need for regional integration in the continent is widely recognised. It is not only the policy-related (i.e. customs and monetary) obstacles to trade, but also the shortfalls in regional infrastructure – be they in telecommunications, transport or energy supplies – that contribute to the low levels of transactions between African countries (even neighbouring ones) and to their relatively low economic growth rates. A recent study on the potential impact of more integration of countries within certain African country groupings estimates the economic gains to be close to 2% (Geourjon *et al.,* 2013). The two main reasons for this acceleration in the growth of a country resulting from regional integration are (i) the increase in the size of the country's economy, allowing diversification and higher productivity; and (ii) less vulnerability to external shocks, as measured by the instability of exports of goods and services, which is reduced in an extended space. Regional integration can thus be seen as a way to reduce vulnerability to exogenous shocks, and is also a factor in enhanced resilience through better and interlinked national economic policies.

In spite of 50 years of efforts to promote regional integration as a key element for Africa's development, progress remains stunted by nationalism in fledgling countries as well as frequent fragility of these countries, making them reluctant to get involved in long-term collective projects. Other factors behind the slow progress in integration are unwieldy regional processes and procedures, the absence of reliable analysis of the impact of integration projects, and insufficient funding dedicated to these projects.

Since its outset (and according to its statute), the main mission of the African Development Bank (ADB) has been to promote regional economic integration. It can put itself in a particularly advantageous position when it comes to overcoming these challenges:

- by respecting the sovereignty of those states that need to take ownership of economic policies;

1 This chapter relies on a study by the authors commissioned by the African Development Bank (see Guillaumont and Guillaumont Jeanneney, 2014a)

- by taking into account the fragility of certain states;
- by proposing simple, straightforward procedures which could mobilise new resources; and
- by relying on a solid analysis of the expected impacts of integration.

Over a number of years, the ADB has increasingly financed regional projects, mainly in infrastructure. The proportion of the African Development Fund (ADF) (out of the specific ADF budget and its national allocations) and of the ADB window dedicated to regional operations is higher than that of other multilateral institutions Three measures could be taken to increase still more the African Development Bank's contribution to the regional integration of African economies. First, it would be useful to determine and adopt a new definition of 'operations of regional interest' by prioritising the regional impact of operations over their bi- or multinational dimension. Second, it would be desirable to increase the share of ADF and ADB funding dedicated to regional operations and to mobilise additional resources for these projects. Finally, it would be useful to set up a new system for the allocation of resources devoted to regional projects. This system could correct the shortcomings of the system currently in use by the ADF, could encourage states to get involved in regional projects, and could also be applied to projects set up by those countries that are eligible for only ADB resources . The new system would be based on a defined indicator of 'need for regional integration', specific to each country, which would help determine the relative share of funding available to the country for regional integration projects.

The principles exposed in this chapter could be applied to other institutions seeking priority actions in favour of regional integration, which could be the case for the European Commission.

1. Broadening and redefining the regional integration projects

A regional integration operation is usually defined as any operation that involves costs and benefits in two or more countries, and that clearly contributes to regional integration or to the supply of regional public goods (AfDB, 2008, p. 9). Therefore, based on the ADB's information system, multinational operations, with their regional scope, are operations taking place in two or more countries. While only those multinational operations that effectively contribute to regional integration are eligible for support from the ADF, it appears that this is not necessarily true of all multinational operations funded by the ADB (AfDB, 2012, p. 4). Moreover, some operations taking place within just one country can have considerable regional impact. Examples of these are improvements to roads or to ports in coastal countries, which facilitate transport to landlocked countries, or the establishment of national training centres that also attract students from other neighbouring countries.

For this reason, regional integration projects should be defined as projects leading to an intensification of economic relations – be they financial, commercial

or migratory – between two or more African countries (Guillaumont, 1978). The durability of this intensification is obviously a major consideration. If a national project's multinational nature (due to its financing or its implementation) would typically lead to such intensification, it can also contribute. It is therefore crucial to take into account the analysis of the expected impact of projects when deciding which qualify for financing within the budget allocated to regional operations.

Broadening the definition of regional integration projects beyond their multinational nature and a more systematic analysis of their impact on integration are two steps to justify a further increase in the share of funding devoted to regional operations by the ADF. As we will see, this increase is essential to the implementation of the instrument proposed in this chapter.

2. Increasing the share of resources dedicated to regional operations

Looking at the ADB Group's operations as a whole between 2000 and 2010, the share of multinational operations increased from 5.9% to 15.4% of the total number of approved projects.[2] The budget for regional operations in countries eligible for ADF funding increased from 5% with ADF-8 to 10% with ADF-9, then to 15% with ADF-10, 17.5% with ADF-11, 20% with ADF-12, and 21% with ADF-13. This share is higher than in other multinational institutions; for instance, the World Bank's International Development Association (IDA) dedicates 6.6% of its allocations to regional operations.[3] The evolution in the ADF's budget devoted to regional operations is all the more justifiable since the ADB can no longer cope with the volume of requests for ADF funding. In 2011, these requests reached 128% of the planned available funding for the period 2011 to 2013.[4] The mobilised resources are rather modest compared to the priority objective of regional integration.

It seems then not only desirable to increase the ADF budget for regional operations, but also to create an incentive for regional integration for countries that can only apply for direct funding from the ADB. The ADB budget for multinational operations is broken down as follows: 65% is distributed through the ADF, and only 35% is available through the ADB window (ONRI, 2012). In any event, the amount of money allocated to regional budgets remains a political choice.

To guarantee the effective use of regional funding in middle-income countries, it would be necessary to make loan terms more attractive, either through preferential rates or redemption periods or through specific guarantee terms (ONRI, 2012). However, provisions should be made to ensure that these measures do not deplete the ADF's resources.

The ADB's systematic pursuit of partnerships with the European Union (which also promotes regional integration) and the World Bank, and the resulting mutual reliance in the management of regional projects, are one way for international

2 AfDB (2012, p. 5).
3 Percentage calculated for IDA17 from World Bank (2014).
4 Ibid. (p. 6).

partners and African states to reduce costs related to project appraisal and follow-up.

The ADF's current funds allocation system is inadequate, even though its official goal is to encourage countries to carry out regional integration operations. Furthermore, countries that are only eligible for the ADB window do not have the same incentives.

3. Designing a new system for the allocation of resources

The objective of the new system is to encourage regional integration more effectively than the system currently used by the ADF and to be applicable to countries eligible for ADB resources only.

The current system and its shortcomings

One of the ADF-11 innovations was for a third of the cost of regional operations to be taken from the national allocation of the countries involved (except for regional public goods). This share was increased to 40% by the management of ADB over the course of the ADF-12, to enable the funding of more projects and to meet funding requests.[5]

The regional budget, which funds two thirds of regional projects, is therefore presented as an incentive for countries to finance integration projects without jeopardising their ownership of these projects. However the share taken from the national allocation is limited to 10% when the national allocation represents fewer than 20 million units of account (UAs). This limit affects nine countries. This rule is based on the notion that smaller countries – which receive a smaller allocation, since it is determined by population size – have a greater need for regional integration than larger countries.

This upper limit for smaller countries has its drawbacks, however, because it brings about a discrepancy in the incentives countries normally have to get involved in regional operations. For example, let us suppose that a country's allocation increases from 19 million to 21 million UAs (similar to Guinea's former allocation) and that this country wishes to participate in a regional integration project and contribute 36 million. Had this country's allocation remained 19 million, it would have had to draw 1.9 million from its national allocation for this project and would still have 17.1 million available for its national projects. However, with an allocation of 21 million, the country must finance 40% of 36 million (i.e. 14.4 million) from its national allocation and only 6.6 million would remain for national projects, instead of the former 17.1 million.

Moreover, the share each country is assigned in the funding of a regional project (i.e. the share that determines the level of their contribution) is not calculated based on the economic benefits the countries will draw from the projects, but on the relative cost of the project that is carried out within their borders. For example, for a road the share would be determined by the distance covered within a country's territory. It is obvious that a large coastal country would be

5 Although this share should be maintained for the ADF-13, exceptions may be made to allow fragile states to limit their contribution to 33% of the total sum.

forced to contribute a greater amount towards the construction than a small neighbouring landlocked country , although the latter, thanks to the road, would open up more and benefit more from the project.[6] In short, it is very difficult to appraise how much each country involved in regional projects benefits from the regional reserve budget.

A new system for the ADF to promote regional integration

The contributions by countries to regional projects though their national allocation is only one of many conceivable ways to encourage governments to implement this sort of project and to engage in these issues. We propose a new allocation system for the regional budget, determined by the relative need for regional integration, which would remain independent of national allocations.

The system would define a potential additional allocation for each country, determined by their regional integration needs. This additional sum would be exclusively dedicated to funding regional operations. Each country would be assigned a *Regional Drawing Right* (RDR), the level of which would depend on the country's *need for regional integration*. How this 'need' could be measured is specified later in this chapter. A country's contribution to regional integration projects would no longer come out of its national allocation, as has been the case so far, but would be taken from its RDR. The total drawing rights would only represent a certain share of the regional budget. The rest, a non-allocated share of the regional budget, would serve to fund projects that are not tied to a specific country, such as regional public goods, or to further complement funding for particularly relevant projects over and above the RDR.[7]

In order to keep the amount of funds devoted to regional projects the same under this new system, the regional budget would have to increase since the levy on national allocations would be discontinued.[8] This increase in the regional budget could be subsidised either by reducing the budget devoted to national allocations, or preferably by mobilising additional resources for this specific purpose. The hope is that this new instrument will act as an incentive for funding bodies.

Thus each country would have a real incentive, in proportion to its need for regional integration, to look for regional integration projects, which would no longer reduce the budget for national projects. Each country, or combination of countries, would be able to submit integration projects to be financed with its drawing rights, and could potentially benefit, in varying proportion, from the reserved part of the regional budget or the non-allocated RDR. This contribution would vary across projects depending, in particular, on the ADF's appraisal of

6 This problem is exemplified by the road running between Mombasa in Kenya and Kampala in Uganda.

7 If the share of the regional budget devoted to the RDR is not completely depleted, the remaining funds can go to increasing the share of the regional budget that is not previously allocated to specific countries.

8 The regional budget would have to increase by 66% approximately in order not to reduce the financing of regional integration (40/60). This calculation does not take in account the rule according to which the small countries contribute only to 10% of the regional projects.

their relevance to the public interest. Compared to the current system, this new system would encourage governments to seek more involvement in projects of regional interest. It should also help the African Development Bank to better promote regional integration projects in which the regional benefits go beyond the sum of the benefits for each individual country involved. The basic reason is that the benefits of a regional integration project for each country are not proportional to the share of the project located in that country. Moreover, countries that are asked to participate in a project that might not be very beneficial for them would have less reason to refuse, since their contribution would be taken from funds specifically devoted to regional projects. The ownership by the states of projects of regional scope would result from their obligation to prove the integration impact of their projects when applying for regional funding from the ADF or the ADB.

It might also be appropriate to adjust the RDR depending on each country's commitment to regional integration. This would be done by combining an indicator of commitment to regional integration with the indicator of need for regional integration. The adapted indicator would thereby also reflect a country's desire to be involved in regional integration, i.e. its *'perceived' need for integration.*

It should be pointed out that each country could use its drawing rights on the regional budget to finance not only projects in its own territory, but also projects in another country if it deems the projects to be in its interest and the other country agrees. Generally speaking, the sharing of each country's RDR should not automatically be the result of the project's localisation, but of an agreement between African states, based on each country's interest in seeing the project completed.

Defining an indicator of need for regional integration

This initiative calls for the establishment of an indicator of need for regional integration whose relevance is crucial for the new system to operate. It appears necessary that this indicator should include an *indicator of size of the domestic market.* Small countries have a greater need to increase their potential market in order to benefit from economies of scale. Moreover, small countries lack economic diversity and are more vulnerable to external shocks. They are therefore more dependent on a regional community through which they can undertake greater investments, improve their capacity to absorb shocks thanks to diversification, and share the burden of risks thanks to intraregional flows of private and public capital and migration. This is why the size of the economy should figure predominantly in the indicator of need for regional integration, with low GDP – resulting from a small population and low income per capita – implying greater need for regional integration.

A second essential, and obvious, criterion when calculating the need for regional integration for each country is *distance from foreign markets.* This is not only related to a country's geographical remoteness and isolation, but also to the condition of its infrastructure. These causes of increased trade costs, and therefore

of reduced competitiveness, can be addressed by regional infrastructure projects. If a suitable indicator for infrastructure could be found, it should be integrated into the indicator of remoteness. This indicator would then take into account not only geographical remoteness, but also the poor condition of infrastructure.

So the indicator of need for regional integration would be based on two indicators reflecting:

- the size of domestic markets, and
- remoteness from foreign markets, into account both the geographical isolation of the country and the state of infrastructure.

Besides deciding which elements should be taken into account when calculating the indicator of need for regional integration, there are also the questions of their standardisation as indicators through a minmax procedure, the weight given to each factor (which will have to be arbitrary), and the type of mean value used for the aggregation of the components. With the simpler option of using two criteria (size of domestic market and remoteness from foreign markets), equal weighting could be an acceptable solution.[9,10]

If a country's commitment to regional integration is to be taken into account, it could be measured through an indicator of regional integration policy such as that already used by the ADB's Country Policy and Institutional Assessment (CPIA), and similar to that which is being considered for the CPIA's new E cluster for ADF-13.[11] In order to calculate the adjusted indicator of (perceived) need for regional integration, the indicator of regional integration policy could be introduced with a variable weighting, depending on the importance it is given. A simple solution would be to make it a third major component of the indicator of need along with size of market and remoteness, giving the components an equal weighting of one third each.

Extension to countries not eligible for ADF funding

This potential formula for allocating funds could be applicable to the ADF, and also to the ADB. It is in fact important that it is applied to the ADB window so that all countries potentially participating in regional integration projects have incentives to commit to projects, in particular when the parties involved are both ADF countries and middle-income countries.

There is currently no system whereby the Bank's *ex ante* allocations per country are likely to be covered by a regional budget. The allocation results ex post from

9 A method for calculating the need for regional integration and the drawing right on the regional budget is presented in Guillaumont and Guillaumont Jeanneney (2014a). Details on the indicator can also be found in Guillaumont and Guillaumont Jeanneney (2014b).

10 If one wanted to retain the current system of drawing part of the funding for regional projects from the national allocations, it would at least be desirable to modify the contribution depending on each country's need for regional integration. Instead of being proportional) as it is today and being restricted by an upper limit, the amount taken from the national allocation would be regressive and based on the need for regional integration.

11 For ADF-13, a country's commitment to regional integration is included in a new cluster with policy to improve infrastructure, after clusters A to D. Previously, it was included in cluster B 'Structural policies', together with economic cooperation and the promotion of trade.

loan demands. As mentioned above, it is conceivable that a budget for regional projects could be created from the resources available for loans from the ADB. Its distribution amongst countries could be determined using the same criteria as those used for the ADF's regional budget, namely the indicator of need for regional integration for each country. Since it is necessary for ADB borrowing countries to have an interest in using these resources, it would be necessary to create incentives such as those proposed in the ONRI document cited above. As well as the technical support already provided, these incentives could come in the form of preferential financial terms for sovereign loans and guarantees for non-sovereign loans in order to encourage the private sector's engagement in operations of regional interest.

Whichever modalities are chosen, the subsidisation of multinational or regionally oriented loans will have a cost. To cover these costs, the ADB will have to mobilise resources that will determine the regional budget. In any case, it is desirable for this budget to exceed the total amount of funding currently dedicated to multinational projects. Moreover the mobilised resources must be sufficient to make the incentives effective and, according to an equity principle, to be in proportion with the budget devoted to the ADF's regional operations.[12] Once more, the definition of a new instrument for regional integration applicable to countries eligible for the ADB window and that would encourage the involvement in regional projects of all African countries would be a way to mobilise further international resources.

Some simulations

In order to test the adequacy of the proposed method, we have run some simulations to determine the need for regional integration of African countries and their corresponding drawing rights, according to various calculation options. The results of these simulations are available in Guillaumont and Guillaumont Jeanneney (2014a) .

Naturally, the classification of countries varies depending on which calculation method is used, but certain elements appear to remain consistent throughout. Ten countries appear to have the greatest need: São Tomé and Principe, the Comoros, Lesotho, Guinea Bissau, the Central African Republic, Cape Verde, Zimbabwe, Burundi, Swaziland, and the Seychelles. These are either small island countries or small landlocked countries. Of these countries, only Swaziland (small landlocked) and the Seychelles (small island) are not eligible for ADF funding. On the other hand, among the countries least in need of regional integration are four North African countries (Algeria, Tunisia, Morocco and Libya), the two countries whose domestic markets are the largest (South Africa and Egypt), three ADF-eligible countries (Ghana, Sudan and Nigeria), and one LDC not eligible for ADF funding (Angola).

12 If the financial conditions of the loans for regional integration are uniform, the distribution of the RDR can be based on the amount of money borrowed. If these conditions are variable, it would be more logical to base the RDR on the amount of subsidies.

4. Supplementary measures to support regional integration

Regional integration, and its contribution to African development, does not only depend on the realisation of investment projects with a regional orientation by one, two or several countries.

Another way to increase regional integration would be to devote a part of the (increased) regional budget to supporting regional cooperation. Not only would regional projects be funded, but budgetary aid would also be given to countries to support the coordination of economic policies, in particular to offset the transitional losses in tax revenue incurred by the creation of a customs union.

Moreover, it would be desirable not only for the ADF, but also for the ADB to support regional institutions (without state guarantees), which would reinforce the institutional aspect of regional integration.

Whether it is dedicated to national budget support in order to prompt states to participate in regional operations or it is dedicated to regional institutions, the funding could be drawn from each country's regional allocations or from the share of the ADF's regional budget not allocated to the countries. In the first case (i.e. in support of national budgets), the funding would be taken mostly from the countries' regional allocations, and in the second case (i.e. to fund regional institutions) it would be drawn mostly from the regional budget.

Conclusion

To sum up, there is great (and widely recognised) need for regional integration in Africa. Improvements in integration would notably reduce the vulnerability of African countries, which are mostly small economies. Meeting this need is a priority for the African Development Bank. Although significant progress has been made by the Bank to support regional integration, a new commitment and a specific instrument appear necessary. This chapter has outlined what this new instrument could be. Once a total amount of finance for regional integration has been established, the African Development Bank and the African Development Fund would allocate resources to countries according to an indicator of need for regional integration (INRI). The indicator proposed is an average of two indices measuring: (i) the size of the domestic market; and (ii) the distance from export markets, a distance which would itself be adjusted according to the quality of infrastructure. The Regional Drawing Right (RDR) from the amount available would depend on this indicator, on the relative share of population within the eligible countries, and possibly on an index representing the commitment of the country to regional integration.

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14

Potential and Perspectives for Using Guarantees for Development in the Post-2015 Framework

JULIA BENN, CÉCILE SANGARÉ AND MARIANA MIRABILE

1. GUARANTEES IN THE POST-2015 DEVELOPMENT FINANCE FRAMEWORK

Since the first Financing for Development conference in Monterrey in 2002, questions about how private resources (e.g. foreign direct investment, venture capital, securities and other private flows) could best be mobilised for financing development have been at the heart of the political debate on development finance. These questions are even more pertinent today as the international community works to elaborate a new, broader development framework combining social, economic and environmental goals that will call for private sector expertise and resources. This is taking place in the context of rapid change across the development finance landscape – and the fact that many countries, especially in the middle-income group, now have access to a more diverse range of finance, including private capital.

In this context, particular attention is paid to the optimal use of limited concessional financing and a smarter targeting of official concessional resources to least developed and low-income countries. For the others, there is an increased demand for market-like and risk-mitigation instruments, such as guarantees.

In particular, guarantees are increasingly viewed as a valuable alternative to traditional finance for mobilising private resources that can be used in a myriad of ways: i) backstopping financing for large-scale, multi-year infrastructure projects; ii) lengthening the maturities of loans to small enterprises; iii) refinancing municipal utilities; iv) enabling local banks to enter new markets such as mortgage or microenterprise lending; or v) deepening capital markets by facilitating local-currency bond issues. In a larger sense, developmental guarantees are uniquely suited to facilitate investment flows to developing countries and high-risk sectors – and they thus mobilise additional resources beyond those that financial markets would normally provide.

There are no comprehensive and internationally comparable data on the use of these mechanisms to finance development projects and the amounts of private

investment they mobilise.[1] In 2013, the DAC carried out the first ever Survey on Guarantees for Development to fill this information gap and to encourage reflection on the role of guarantees and their potential to achieve development results, especially in the post-2015 development finance framework. The results of this work are presented below.

At their December 2014 High Level Meeting, members of the Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD-DAC) recognised the importance of guarantees and other private sector instruments to unlock private investment and help mobilise additional resources for sustainable development. They also agreed to pursue data collection and expressed support for continued work to develop an international standard for measuring amounts mobilised from the private sector through official interventions.

2. In figures

This section provides basic information on the magnitude, geographic spread and characteristics of developmental guarantees, based on the DAC Survey on Guarantees for Development. The data relate to over 1,000 long-term guarantees issued by aid agencies and bilateral and multilateral development finance institutions (DFIs) over the period 2009-2011[2] (see Table 14.A2).[3] The section also includes three boxes: Boxes 1 and 2 describe two different developmental guarantee portfolios, and Box 14.3 presents statistics on the magnitude of short-term guarantees used for development projects. Key terminology and details on the survey sample and methodology are available in Annex A.

2.1. How much?

Guarantees for development – extended by aid agencies and bilateral and multilateral DFIs – mobilised US$15.3 billion from the private sector for development purposes from 2009 to 2011.

The amount mobilised by guarantees – i.e. the cash flow from the private sector in support of projects in developing countries – doubled from US$3.2 billion in 2009 to US$6.4 billion in 2011.

In the overall picture of development finance, the scale of resources mobilised for development through guarantee schemes remains small. In 2011, developmental guarantees covered activities valued at US$6.4 billion, a marginal amount compared to ODA (US$134 billion in 2011).

1 Part of the reason for the lack of information is that guarantees are ‘unmaterialised’ financial flows: as ‘contingent liabilities’, they are registered in the financial statements of the institutions issuing them but they do not actually give rise to official financial flows until a default occurs. Thus, while the OECD-DAC runs a comprehensive statistical system on financial flows, guarantees in themselves do not appear in it.

2 A new survey is planned in 2015 to update the figures.

3 Long-term guarantees cover risks for one year or more. Data on short-term guarantees were collected at an aggregate level due to confidentiality issues, and could therefore not be included in the overall data analysis. An overview of short-term guarantees is presented in Box 14.3.

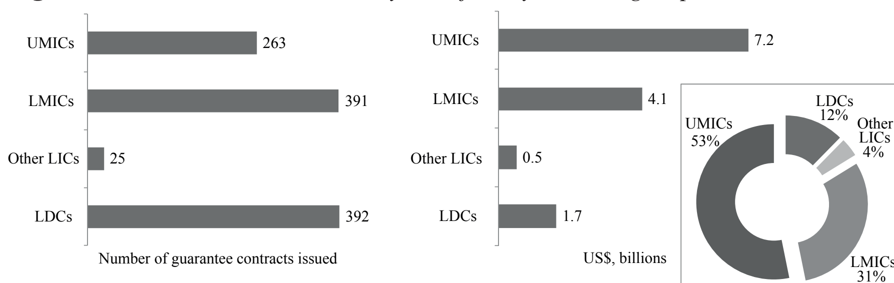
Also, the results of the survey highlighted that the boundary between guarantees for development (as defined in the questionnaire) and guarantees extended with a commercial motive (such as those extended by export credit agencies) is not sharply defined. Developmental and commercial motives could even be interdependent, for example, when commercial viability is a condition for a publicly funded development institution to guarantee a project.[4]

2.2. To whom?

More than 50% of the resources mobilised by guarantees benefited upper-middle income countries

In terms of the number of guarantees issued (Figure 14.1, left-hand side), almost 40% of the contracts issued benefited least developed countries (LDCs). However, in terms of the amount mobilised, more than 50% of the total resources mobilised went to upper-middle income countries (Figure 14.1, right-hand side). This information suggests that contracts were significantly smaller in size in LDCs. The average risk exposure (not shown in Figure 14.1) did not vary significantly between income groups.

Figure 14.1. *Amount mobilised by beneficiary income group*



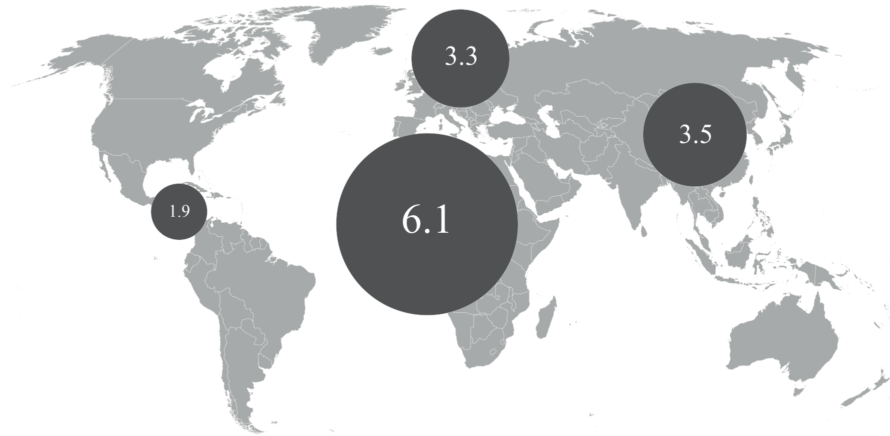
Notes: LDCs: least-developed countries; Other LICs: other low-income countries; LMICs: lower-middle income countries; UMICs: upper-middle income countries.

Africa was the region benefiting the most from guarantees

The region benefiting the most from guarantees was Africa, followed by Asia and Eastern Europe (41%, 24% and 22% of the total amount mobilised, respectively). Over one third of the resources made available in Africa went to upper-middle income countries (UMICs) – in particular to Botswana, Tunisia and South Africa – while another third benefited LDCs and 'Other LICs'. In terms of the number of contracts, over 650 guarantees were issued in Africa, 201 in Asia, 74 in Europe and 143 in Latin America. Contracts issued in Africa were significantly smaller than those issued in other regions. A list of beneficiary countries is included in Annex B.

4 Operating on a commercial basis is a criterion for project eligibility for most DFI and multilateral DFI funding and guarantees.

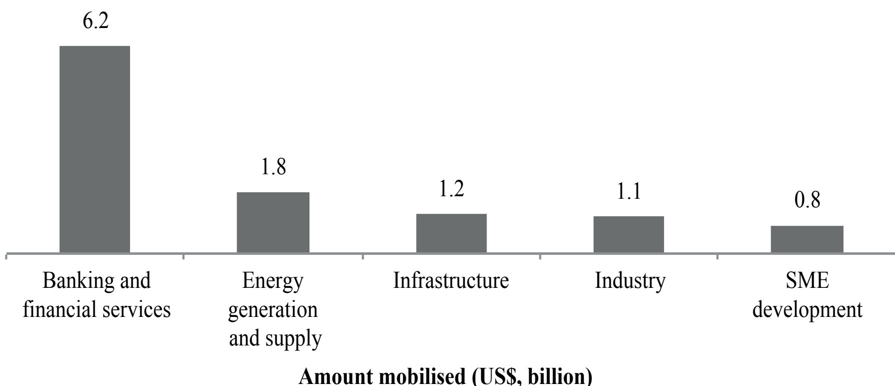
Figure 14.2. *Regions benefiting from resources mobilised by guarantees (US$ billion)*



The banking and financial services sector benefited the most from guarantees

Figure 14.3 shows the top five sectors benefiting from guarantees.[5] Guarantees were mainly used for banking and financial services, such as credit lines for micro-finance loans, improvement of portfolio structure and refinancing. Guarantees were not widely used for climate-change-related projects (only 25 guarantees out of over 500 for which information is available).

Figure 14.3. *Top five sectors benefiting from guarantees*



5 The sector codes used in this analysis are a subset of the OECD/DAC codes. Although respondents were encouraged to use OECD/DAC sector codes, many used their institutions' internal codes. In order to undertake the sectorial analysis, the information on the main sector, sub-sector and project description was used to map each institution's codes to those of the OECD/DAC.

Box 14.1. *Examples of projects supported by ARIZ, the guarantee programme of the Agence Française de Développement*

Madagascar

BIONEXX is a Malagasy company that grows and purifies artemisia, a plant from which an active ingredient that can fight malaria is extracted. The activity includes a far-reaching programme whereby a large community of small-scale farmers works for the company. The company obtained a five-year loan from a local bank with a 50% ARIZ guarantee and was consequently able to pursue its development. BIONEXX grows around 450 hectares of artemisia and has already created 700 jobs. The company should eventually provide employment to 2,000 people.

Cameroon

KETCH SARL, with its 412 employees, is one of Cameroon's biggest SMEs specialised in road works.

Growth in activity led the company to make investments in both equipment and human resources by recruiting young Cameroonian executives. In 2008, ARIZ guaranteed financing for equipment.

Haiti

ACME began its microfinance activities in Haiti's urban areas ten years ago. In 2008, ARIZ guaranteed a line of bank financing to this microfinance institution (MFI). The MFI was consequently able to improve its operational capacities, develop its credit portfolio and acquire an information and management system. ACME has allocated some 100,000 loans over the past ten years via its network of 15 agencies, mainly in Port-au-Prince. It is one of Haiti's biggest MFIs.

Source: AFD.

2.3. *By whom?*

Over 50% of the amount mobilised was guaranteed by multilateral DFIs

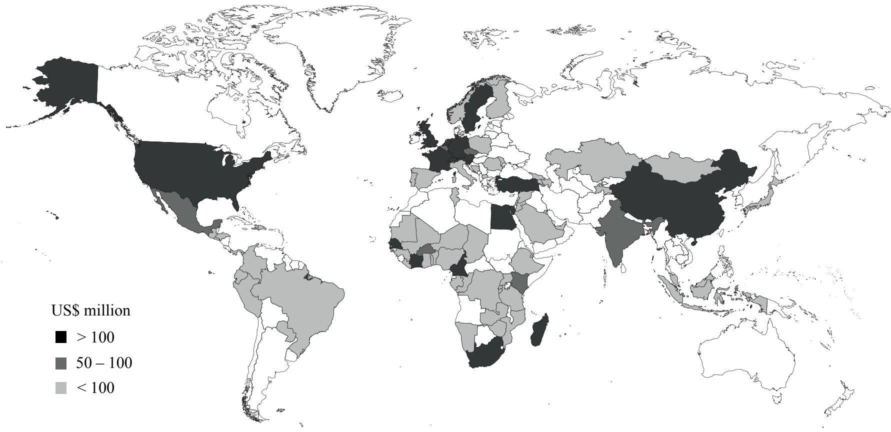
More than half of the resources mobilised were guaranteed by multilateral DFIs, likely due to their: i) strong treasury and co-financing operations, ii) leading role in infrastructure/big ticket investments, and iii) comparatively large average guarantee exposures (particularly regarding political risk guarantees given by the Multilateral Investment Guarantee Agency). On the other hand, several bilateral institutions stated that, being obliged by law to offer only ODA-eligible financial products, they could not include guarantees in their portfolio.

15% of the resources mobilised by guarantees were domestic

Figure 14.4 shows the origin of the private flows mobilised and their amounts. Even if most of the guarantees (85% by value) backed capital that was mobilised

in OECD countries, there is scope for making greater use of developmental guarantees to tap local savings and develop domestic capital markets in the developing countries where these guarantees are being used.

Figure 14.4. *Amount mobilised by origin of funds*



Box 14.2. *GuarantCo: Facilitating local currency finance and deeper capital markets*

GuarantCo is a special guarantee facility established in 2006 under the aegis of the Partnership for Infrastructure Development (PIDG), a multi-donor organisation working to mobilise private sector investment in infrastructure in the developing world. GuarantCo provides local currency guarantees to infrastructure projects in low-income countries to mitigate credit risks for local banks, thereby promoting domestic infrastructure financing and capital market development. GuarantCo's total guarantee issuing capacity is US$300 million, targeting US$500 million by the end of 2014.

GuarantCo has supported investment in the industrial, telecommunications and transport sectors, each of which accounts for approximately 25% of its outstanding portfolio. Half of its guarantee operations have been targeted at crucial infrastructure investments in fragile states. Recent activities include a credit enhancement for a municipal bond issue in Kenya, a guarantee for a public-private partnership hospital in Egypt, and partial guarantees for a river hydropower project in Nepal, a slum redevelopment project in India and a greenfield agro-energy project in Tanzania.

Source: Guarantco.

2.4. Main characteristics of guarantees issued for development

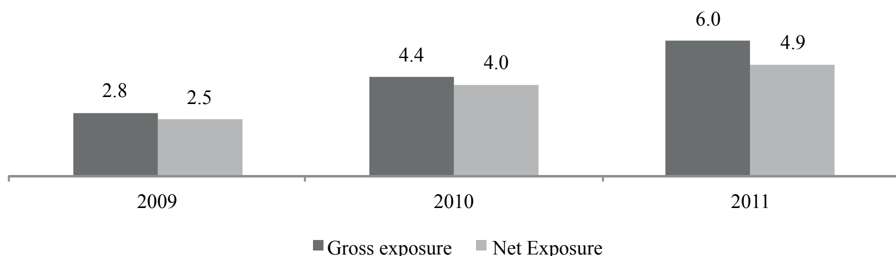
Guarantees covered political risks, commercial risks or both. The size and coverage of political risk guarantees – mainly issued by multilateral DFIs, and in particular by the Multilateral Investment Guarantee Agency (MIGA) – is significantly higher than those of commercial risk guarantees (Table 14.1).

Table 14.1. *Guarantees by type of risk covered*

Risk covered	Average amount mobilised (US$ million)	Average gross exposure (US$ million)	Percentage coverage
Both commercial and political risks	42	36	87%
Commercial risk	4	2	44%
Political risk	18	18	99%

When reinsurance is used as a means of risk management, the risk assumed by the guarantor is measured by the net exposure (Figure 14.5). Five institutions used reinsurance to manage the risk associated with guarantees; others used their own resources, mainly in the form of capital reserves. Another mechanism to spread risk was the use of co-guarantees (six institutions).

Figure 14.5. *Guarantors' gross and net exposure (US$ billion)*

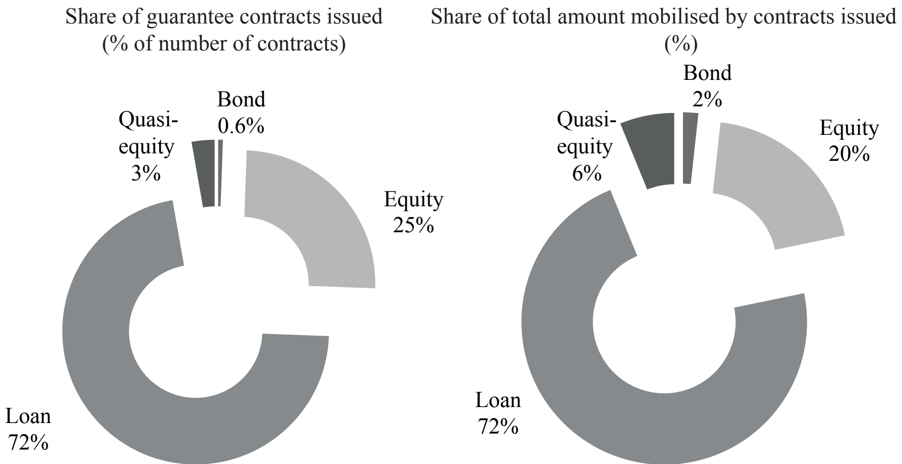


In terms of claims paid, available data from the survey, online research and interviews with guarantor agencies suggest that the provision of guarantees has not typically been a loss-making activity and that the claim rate was very low, of approximately 1-2% of the guarantor's exposure during the period 2009-11.

Guarantees were issued as individual or portfolio guarantees. Individual guarantees were more widely used and covered, on average, a higher proportion of the risk than portfolio guarantees.

Loan guarantees were more widely used than equity, quasi-equity and bond guarantees. Over 70% of the guarantees in the sample covered loans in terms of both number of contracts and amount mobilised (Figure 14.6).

Figure 14.6. *Instruments covered by guarantees*



Box 14.3. *Short-term guarantees: Trade Finance Programmes (TFPs)*

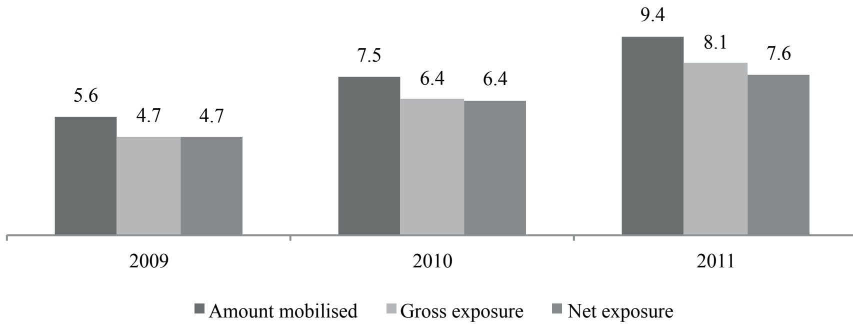
Trade Finance Programmes (TFPs) – or short-term guarantees – fill market gaps for trade finance by providing guarantees and loans to banks to support trade. TFPs provide companies with the financial support they need to engage in import and export activities in the most challenging markets. The differences between TFPs and export-credit guarantees are:

- the guarantor agency's mandate is developmental in the former and export-facilitating in the latter;
- operations are not tied for TFPs, as the guarantor is a multilateral DFI and not a specific country; and
- most TFP operations are exports or imports between developing countries.

In addition to the US$15.3 billion mobilised by long-term guarantees, TFPs mobilised over US$22 billion from 2009 to 2011. These data refer to short-term guarantees issued by the European Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank and International Finance Corporation. Data on TFPs are not fully comparable to those on long-term guarantees due to the use of a different definition of amount mobilised to that proposed in the survey.

Box 14.3. *(contd.)*

Figure 14.7. *Amount mobilised by TFPs and exposure (US$ billlion)*



3. Measuring leverage ratios: A word of caution

For any type of transaction, the leverage ratio measures the amount of resources spent on the transaction as a proportion of the resources it mobilised. The amount mobilised is the numerator of the formula, and the effort involved in the action of mobilising those resources is the denominator. A leverage ratio of 6 to 1, for example, means that 1 dollar was needed to mobilise 6 dollars.

According to the survey, guarantees mobilised over US$15 billion from the private sector (the numerator in the above formula) for development purposes during the period 2009-2011. The amount mobilised is of particular interest for analyses from the recipient's point of view, as it shows how many resources were made available to developing countries through guarantees.

Measuring the effort involved to mobilise these resources – the denominator in the leverage ratio calculation – is less straightforward in the case of guarantees, as the public institution effort is not immediately clear in the form of a discrete payment. Proxies to quantify the effort by the public institutions could be the risk taken by the guarantor, claims paid or capital subscriptions to the institutions issuing guarantees.

Beyond the difficulty of measuring the leverage ratio of guarantees, a reflection on this ratio as an indicator of effectiveness in the case of guarantees is also due. Regardless of which measure is used to quantify the effort (denominator), one should keep in mind that the leverage ratio does not depend only on the catalytic effect of a given financial instrument, but mainly on the context, market conditions, and sector in which the instrument is being deployed. For example, a guarantee is likely to mobilise more private resources in India than in Afghanistan. Also, the resources mobilised from the private sector by using any given instrument in the energy sector are likely to be greater than the resources that could be mobilised for a social investment, such as education or water supply.

In annual reports, the leverage ratio is often used at the institutional level to measure the strategic use of resources, or 'efficiency' of the instruments being used, to mobilise private sector resources: the higher the leverage ratio, the greater the resources mobilised in proportion to the resources allocated by the public institution, and the more efficient the institution. However, since the ratio is so dependent on context, it is likely that any instrument, if used in LDCs, will have a lower leverage ratio than the same instrument used in MICs (the public sector efforts needed to make investments in LDCs attractive to the private sector are likely to be higher than those needed in MICs).

The leverage ratio therefore needs to be interpreted with care. If the leverage ratio maximisation is seen as a measure of the institutions' 'efficiency', there is an implicit incentive to invest primarily in MICs, as these are the countries where the context would allow such maximisation. It is therefore crucial to avoid comparing the leverage ratio of market-like instruments such as guarantees with the mobilisation potential of other more traditional instruments, such as grants and concessional loans. If ODA is invested in those countries most in need of external development finance, the leverage ratio of these instruments will certainly be lower than the leverage of a guarantee invested in an MIC, and such a difference will be mainly driven by the context in which the instrument is being invested and not necessarily by the efficiency of the institution deploying it.

Another consideration to take into account if using the leverage ratio is that, in terms of attribution of the amount mobilised, the higher the leverage ratio, the less likely that the resources mobilised can be attributed to the public intervention. This is because if the investment being analysed represents a small proportion of the total project cost, it is likely that the project would have been implemented anyway, even without this investment.

4. Conclusion and way forward

Guarantees for development supported a total of US$15.3 billion from private sector actors for investments in the developing world from 2009 to 2011, and the volume doubled from US$3.2 billion to US$6.4 billion over the period. Nevertheless, they were a marginal component of development finance when compared to traditional aid over the years in question.

Arguably, the use of guarantees could be expanded where market conditions – such as sound regulatory and legislative frameworks, reliable payment mechanisms and transparent bidding processes – are well-suited to fully exploit the guarantees' potential to mobilise additional resources for development. However, they should be used as a complement to, not a substitute for, more traditional instruments such as grants and concessional loans.

The use of guarantees among providers of development finance is increasing, and some institutions not making use of guarantees today plan to do so in the near future. The expansion of the use of market-like instruments as a complement to more traditional aid has the potential to increase private sector engagement in development projects, allowing public resources deployed through traditional aid to be freed up and targeted to either LDCs – where the market and enabling

environment may still not be ready for these instruments to be deployed efficiently – or to less commercially viable sectors. These resources, in the form of traditional aid, may not have an immediate mobilisation effect today, but if used to improve the market and enabling environment in the countries, they may have a potential long-term catalytic impact, as they are preparing the ground for future private investment. DAC members at their December 2014 High Level Meeting recognised the importance of guarantees and other private sector instruments to unlock private investment and help mobilise additional resources for sustainable development, and supported continued work in this area to establish an international standard for measuring the volume of private investment mobilised by official interventions. Better recognition of these instruments at an international level is expected to help incentivise the use of guarantees, and other market-like instruments, in the future.

Annex A. Survey details: Sample, key terminology and methodology

The survey was organised through the DAC Working Party on Development Finance Statistics (WP-STAT) in collaboration with statistical correspondents in both DAC and non-DAC countries and multilateral DFIs. The sample included aid agencies, and bilateral and multilateral DFIs. The list of countries and institutions in the sample is given in Table 14.A2. Export credit agencies were not included in the sample as development is not their primary objective.

For the purposes of the survey, 'guarantees for development' were defined as guarantees extended with the promotion of the economic development and welfare of developing countries as their main objective. The main objective of the survey was to estimate the volume of private sector flows to developing countries mobilised by guarantee schemes over the period 2009 11. The survey aimed also to: i) explore the feasibility of collecting qualitative and quantitative information on guarantee schemes in the future, as part of statistical reporting on external development finance to the DAC; and ii) contribute to the ongoing reflection and discussions in various forums on how to measure the leverage impact of different instruments used in development finance.

Information was collected at the level of individual guarantees for long-term guarantees[6] issued between 2009 and 2011. Data on short-term guarantees were collected at an aggregate level due to confidentiality issues, also for the period 2009-11.

The survey response rate was 85%, with 20 countries (bilateral institutions) and 15 multilateral DFIs responding to the survey. Overall, 17 countries or institutions provided guarantees for development and four other institutions plan to use these instruments for development in the near future (Table 14.A1).

Table 14.A1. *Responses to the survey by type of institution: Long- and short-term guarantees*

	Bilateral institutions	Multilateral institutions	Total
Issuing guarantees	8	9	17
Not issuing guarantees	10	4	14
Planning to issue guarantees in the near future	2	2	4
Total	20	15	35

From 2009 to 2011, 1,170 long-term guarantees and several thousands of short-term guarantees[7] were issued. Fifty-five guarantees were excluded from the sample.

6 Long-term guarantees cover risks for one year or more.

7 The exact number of contracts issued as short-term guarantees is not available.

The data analysis in Section 2 focuses on guarantees having mobilised funds from the private sector. These guarantees represent over 90% of the amount mobilised in the sample. Intra-agency guarantees were outside the scope of the survey, which may explain the small percentage of public sector funding. Guarantee beneficiaries[8] were also mainly private companies (over 80%); both public and private beneficiaries were included in the analysis.

Key terminology

The term '*guarantee'* refers to a legally binding agreement under which the guarantor agrees to pay part or the entire amount due on a loan, equity or other instrument in the event of non-payment by the obligor or loss of value in case of investment.

Guarantees for development are those extended with the promotion of the economic development and welfare of developing countries as the main objective (i.e. with a *development motive*). The survey followed an 'institutional approach' in the sense that only institutions with a developmental mandate were included in the sample.[9]

Amount mobilised by a guarantee is the full nominal value of the instrument (e.g. loan, equity) to which the guarantee relates, regardless of the share of this value covered by the guarantee (US$4 million in Figure 14.A1).

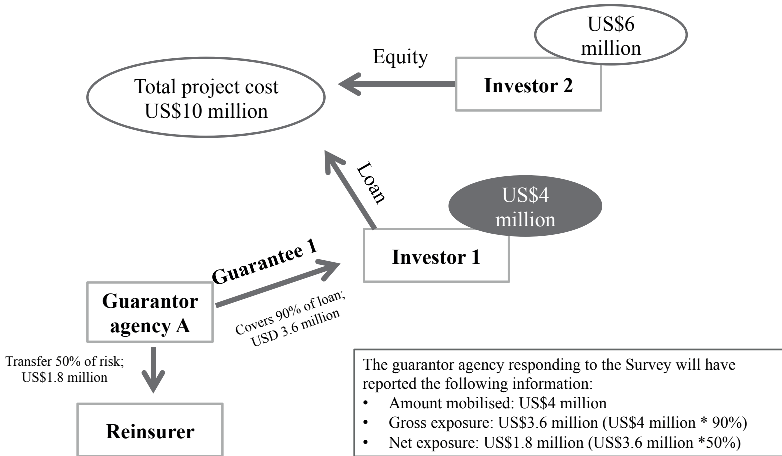
Gross exposure is the full amount the guarantor will pay to the investor if the risk covered materialises, regardless of reinsurance (US$3.6 million in Figure 14.A1).

Net exposure is the gross exposure minus the amount the guarantor would recover through reinsurance (US$1.8 million in Figure 14.A1).

8 The beneficiary is the entity in the developing country where the ultimate investment is made. In the case of loans, it is the borrower whose debt will be paid by the guarantor should the obligor fail to pay its debt to the investor.

9 One member, however, reported a few guarantees issued by the export credit agency on behalf of the Ministry of Foreign Affairs.

Figure 14.A1. *Amount mobilised, gross and net exposure in survey (example)*



Methodology: The difficulty and subjectivity of measuring the impact of guarantees

The terms 'mobilising', 'leveraging' and 'catalysing' private flows are frequently used in discussions on development finance, but no internationally agreed definitions of these terms exist. While many organisations publish data on their leveraging, their calculation methodologies vary. Indeed, the meaning of these terms differs according the instruments they refer to (e.g. loans, guarantees) and the actors involved in the transactions (e.g. development agency, private sector).

The Survey on Guarantees for Development enabled the DAC to deepen the reflection on how to present and measure the impact of these instruments. In particular, the survey assessed two different approaches to measuring the amount of resources mobilised by a guarantee: i) using the total value of the project with which the guarantee was associated; or ii) using the total amount of resources (e.g. loan, equity) mobilised by a specific guarantee.

The analysis identified two problems with the 'total value of the project' approach:

- Where a guarantee covered only a small share of the total project cost, it would be difficult to assert that it played a crucial role in the decision to make the investment. Accordingly, measuring the amount of resources mobilised in terms of 'total project amount' would overstate the effect.
- If two different guarantees covering different elements of a financing package were both reported in the data, then the 'total value of project' would be counted twice.

On the other hand, causality can realistically be assumed between a guarantee and the loan or investment it covers – particularly where the guarantee covers a large share of the loan – and this was the approach taken in the survey, for

example, the amount mobilised was defined as the amount of the instrument (loan, equity) to which the guarantee related.

Figure 14.A2 illustrates a simple guarantee operation in which a project totalling US$10 million is funded by an equity stake from Investor 1 (totalling US$6 million) and a loan from Investor 2 (totalling US$4 million), with the loan being guaranteed by Guarantor 1. According to the survey, therefore, the amount mobilised by Guarantor 1 in this case was US$4 million.

Figure 14.A2. *Example of a simple guarantee operation*

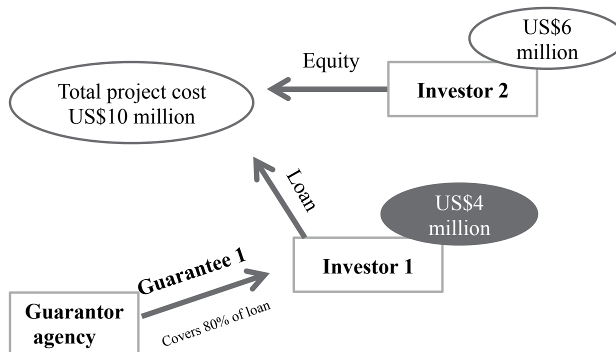


Table 14.A2. *List of countries and institutions in the sample*

Respondents (country and institution)	Guarantees for development?	Amount mobilised 2009-11 (US$, million)
Australia – AUSAID	No response	
Austria - Oesterreichische Entwicklungsbank AG	Yes	304.3
Belgium - DGDevelopment, Ministry of Foreign Affairs	No	
Canada - Export Development Canada	No	
Denmark – DANIDA	No	
European Union - EuropeAid; EIB	No response	
Finland – FINNVERA	Yes	209.1
France - Agence Francaise de Développement; PROPARCO	Yes	1116.1
Germany – KfW; DEG	Yes	62.9
Greece - Ministry of Foreign Affairs	No	
Ireland – DFA	No response	
Italy - Ministry of Foreign Affairs - General Directorate for Development Cooperation	In the near future	
Japan - MFA; JICA; JBIC	No	
Korea – KEXIM	In the near future	
Luxembourg - Directorate for Development Cooperation, Ministry of Foreign Affairs	No	

Respondents (country and institution)	Guarantees for development?	Amount mobilised 2009-11 (US$, million)
Netherlands - Atradius, Min. Dev. Coop., DG International Trade, Foreign Ec. Relations	No	
New Zealand – NZAID	No response	
Norway - NORAD; NORFUND	Yes	29.7
Portugal – SOFID	Yes	3.7
Spain – CESCE	No	
Sweden – SIDA	Yes	12.6
Switzerland – SECO	No	
United Kingdom - DFID; UK Export Finance	No	
United States - USAID; OPIC	Yes	5621.2
Asian Development Bank (ADB)	Yes*	
African Development Bank (AFDB)	Yes**	139.5
Arab Fund for Economic and Social Development (Arab Fund)	No	
Arab Bank for Economic Development in Africa (BADEA)	No	
Caribbean Development Bank (CDB)	No	
Credit Guarantee and Investment Facility (CGIF)	In the near future	
Climate Investment Funds (CIF)	No response	
European Bank for Reconstruction and Development (EBRD)	Yes***	
Inter-American Development Bank (IADB)	Yes****	69.8
Int. Bank For Reconstruction and Dev./Int. Dev. Association (IBRD/IDA)	Yes	1496.2
International Fund for Agricultural Development (IFAD)	No	
International Finance Corporation (IFC)	Yes****	1199.9
Islamic Development Bank Group [ISDB (ICIEC)]	Yes	430.9
Multilateral Investment Guarantee Agency (MIGA)	Yes	4467.9
Nordic Development Fund (NDF)	In the near future	
OPEC Fund for International Development (OFID)	No response	
Private Infrastructure Development Group (PIDG) – GuarantCo	Yesb	144.2

Notes: * Issues both long and short-term guarantees. Only short-term guarantees were reported as no long-term guarantee was issued in the period 2009 to 2011. Data on short-term guarantees is not reported in this table as not comparable to long-term guarantee data. ** Issues both long and short-term guarantees. Only long-term guarantees were reported as no short-term guarantee was issued in the period 2009 to 2011. *** Issues both long and short-term guarantees. Both were reported to the survey, however long-term guarantees were excluded from the analysis as the investor was a multilateral organisation (not private). **** Issues both long and short-term guarantees; both were reported to the survey.

Annex B. Countries benefiting from long-term guarantees

Region	Beneficiary country	Amount mobilised 2009-11 (US$, million)
	Algeria	173.2
	Angola	13.6
	Benin	15.2
	Botswana	825.3
	Burkina Faso	84.6
	Burundi	4.1
	Cameroon	176.4
	Central African Rep.	0.8
	Chad	19.5
	Congo, Dem. Rep.	25.4
	Congo, Rep.	19.9
	Cote d'Ivoire	219.8
	Djibouti	25.4
	Egypt, Arab Rep.	72.5
	Ethiopia	224.0
	Gabon	43.8
	Ghana	729.9
	Guinea	12.3
	Kenya	472.7
	Liberia	180.2
	Libya	7.4
	Madagascar	140.8
Africa	Malawi	6.0
	Mali	47.6
	Mauritania	5.3
	Mauritius	53.6
	Morocco	0.2
	Mozambique	36.0
	Namibia	74.8
	Niger	4.9
	Nigeria	368.9
	Rwanda	82.3
	Senegal	378.8
	Seychelles	135.5
	Sierra Leone	12.7
	Somalia	0.1
	South Africa	342.5
	Swaziland	1.2
	Tanzania	28.2
	Togo	54.9
	Tunisia	325.7
	Uganda	42.8
	Zambia	28.0
	Zimbabwe	40.0
	Country not specified	525.6
	Sub-total: Africa	**6082.1**

Region	Beneficiary country	Amount mobilised 2009-11 (US$, million)
	Antigua and Barbuda	0.0
	Argentina	4.0
	Bolivia	12.2
	Brazil	127.1
	Chile	30.0
	Colombia	89.2
	Costa Rica	78.0
	Dominica	0.0
	Dominican Republic	8.7
	Ecuador	15.2
America	El Salvador	34.0
	Guatemala	54.3
	Haiti	63.3
	Honduras	158.9
	Mexico	386.6
	Nicaragua	41.3
	Panama	197.4
	Paraguay	85.2
	Peru	234.2
	Uruguay	0.1
	Country not specified	246.7
	Sub-total: America	**1866.3**
	Afghanistan	107.3
	Armenia	23.0
	Azerbaijan	67.5
	Bangladesh	9.1
	Cambodia	17.1
	China	254.7
	Georgia	104.3
	India	392.5
	Indonesia	762.3
	Iraq	32.3
	Jordan	154.7
	Kazakhstan	381.9
	Kyrgyz Republic	8.0
Asia	Lebanon	90.9
	Mongolia	45.3
	Nepal	0.3
	Pakistan	169.5
	Philippines	48.0
	Sri Lanka	26.7
	Syria	9.3
	Tajikistan	4.8
	Thailand	306.1
	Timor-Leste	0.2
	Uzbekistan	0.8
	Vietnam	102.4
	West Bank and Gaza	102.6
	Country not specified	326.3
	Sub-total: Asia	**3547.8**
	Albania	117.3
	Bosnia and Herzegovina	243.4
	Kosovo	74.0
	Macedonia, FYR	202.3
Europe	Moldova	38.7
	Serbia	1172.4
	Turkey	1053.3
	Ukraine	222.4
	Country not specified	149.8
	Sub-total: Europe	**3273.5**
	Multiple regions	527.8
	Total	**15297.6**

PART THREE

FINANCING SOCIAL AND POLITICAL SUSTAINABILITY

15

Diversifying the Economies of Fragile African States: How Donors Can Help[1]

Paul Collier

1. Introduction

Necessarily, donors will focus increasingly on fragile states. The more successful countries in Africa are now gaining access to global capital markets and so aid is becoming marginal. In contrast, fragile states, by the nature of their condition, have small tax bases and face risks that deter private capital; for them, aid remains potentially important. Fragile states seldom develop autonomously because they lack the preconditions for integration into the global economy: their economies are small and isolated and this inhibits the diversification of private economic activity. The governments of fragile states generally lack the resources to break out of this trap. Hence, for the economy to develop, donors need strategies that address this distinctive constraint: they must help the country to break out of isolation, but this breakout itself requires private investment that may not be forthcoming without donor action. Section 2 sets out why private investment in fragile states is distinctive: because much of it involves pioneering, it generates externalities and so is insufficient. Based on this analysis, Section 3 then turns to the scope for donor action.

2. Why private investment in fragile states is distinctive

Isolation sometimes occurs because fragile states are landlocked and dependent for access to global markets on neighbours that have not provided adequate transport infrastructure. Other fragile states are coastal and potentially integrated into the global economy, but have inadequate transport logistics. Isolation is greatly aggravated by the small size of economies – the domestic market is tiny and the global market inaccessible. South Sudan is an example of such an economy. Activity is dominated by pastoralists generating a low level of income and the country is extremely isolated: the route north through Sudan is periodically cut off due to political tensions, and the route south depends upon unpaved roads to reach the neighbouring countries of Uganda and Ethiopia, which are themselves small economies that are landlocked with very high transport costs to global markets. Because of these extraordinary circumstances, South Sudan is a useful paradigm, but other countries and regions, such as Sierra Leone, Liberia and

1 A longer version of this chapter was first published as Ferdi Working Paper No. P95 (Collier, 2014).

the Sahel, also have these fundamental features of being small, pre-modern and isolated. The growth process in such economies is fundamentally different from that in integrated economies, and so calls for distinctive donor policies.

Like South Sudan today, eighteenth-century Britain was also small and predominantly isolated. Adam Smith witnessed the emergence of the modern economy alongside the traditional economy. What struck him most powerfully were the scale economies that came with specialisation as the artisanal mode of production was superseded by factories. This is one key aspect of the contrast between the pre-modern economy and the modern economy. The early stages of reaping scale economies permit staggering increases in productivity. Soderbom (2012) studied productivity in Ethiopian manufacturing and found the same pattern that had impressed Smith. The productivity of workers in firms that had 50 employees was *ten times* that of workers in firms with four employees. Of course, a firm with 50 employees remains very small in comparison with how most workers are organised in a modern economy, but in small, isolated economies most of the labour force is not even in firms of this size; it is self-employed in one-person enterprises.

Market size matters not just in respect of ability to reap scale economies in production, but also in respect of the intensity of competition. Competition forces both static and dynamic gains in efficiency through discipline and selection effects. Where the market is too small, the economy faces an unsatisfactory tradeoff between having insufficient firms to support a competitive market and having a larger number of firms that are each too small to reap scale efficiencies.

A second feature of the modern economy is a consequence of advanced specialisation and so was only in its infancy at the time of Adam Smith, namely, the inter-dependence of activities. In the pre-modern economy each enterprise, though tiny, is virtually self-sufficient. It produces a product with no inputs other than capital and labour. This characterisation of production – an output produced under constant returns to scale by capital and labour – remains the workhorse model of elementary economics textbooks and, for some purposes, it is a reasonable description of the pre-modern economy. But as a characterisation of the modern economy it is misleading. For example, modern manufacturing is increasingly characterised by intense specialisation – ‘trade in tasks’. The typical firm buys in a wide range of material inputs, undertakes one stage of transformation, and sells its output to another firm that, in turn, uses it as an input into its own process of transformation. Indeed, in the modern economy much of the capital that a firm uses in the production process is hired in rather than owned: buildings are rented and equipment is leased. Hence, the flow of services from capital is conceptually simply another material input. Further, the share of labour in the cost of the firm’s output is often small. While production in such an economy is not well-characterised as being dependent upon capital and labour, it is highly interdependent: in the limit, every activity depends upon every other activity.

Africa’s fragile states have neither scale nor interdependence. Typically they consist of smallholder agriculture or pastoralists, plus an extractive sector that

operates as an enclave. In the limiting case, transport costs for all the products of the modern economy are initially prohibitive. This was, in effect, the Britain of Adam Smith: the modern economy existed only in the future and its products could not be transported from that future to Smith's era. Smith's economy could only grow by the process of building, activity by activity, components of the modern economy. The growth process in Smith's time is conventionally portrayed as being one of a sequence of innovations. But this sequence was arguably less the result of random inventiveness than a sequence of new activities that was pre-determined by what the market could utilise. There was simply no point in inventing the internet in the late eighteenth century, because none of the activities that such an invention needs in order to be useful was then available. This, rather than the slow pace of invention, may have been the real constraint upon the growth process. Indeed, neither the internet nor any of the activities that constitute a modern economy were initially feasible. The sequence of ascent to the modern economy was by way of a host of activities that were essential as stepping stones but which then became redundant: the sinews of the nineteenth century industrial economy were such things as candles, ropes, wooden ships, coal and iron.

2.1. Why isolation constrains the opportunities for investment

Now consider how such a country develops into a modern economy. One path is that the economy develops by ceasing to be isolated. Transport costs are radically reduced through investment in transport logistics, as a result of which it becomes a normal part of the global modern economy. Firms and households simply import all those goods and services that cannot be produced at world standards of efficiency. Such a globally integrated small economy will be highly specialised in a few activities, importing most of its needs – Dubai is an example.

However, investment in transport logistics may not be privately profitable. This may be because many of the returns to the investment cannot be captured by the investor, or the impediment to private investment in transport may be a lack of coordination between transport investment and other investments. The return on investment in transport may be endogenous to the development of the economy. Like other modern activities, the productivity of transport depends upon its scale of operation and the availability of the many inputs on which it depends. Only if many other investments occur will investment in transport become profitable.

It is also entirely possible that even if all returns could be captured by the investor, they may not be high enough to yield a competitive return on the investment. For example, nothing guarantees that the huge investment required to integrate South Sudan into the global economy would ever have a high return. The market-driven growth process of the nineteenth century achieved integration of the population into the modern economy predominantly by migration: people moved from the pre-modern rural economy to the modern urban economy, often located in a different country.

Hence, while sufficient investment in transport may overcome isolation, there is no guarantee that this investment will occur through the market. Further, if the

logistical problems are in part a result of misgovernance, it may not be possible to overcome them by private investment in transport.

Now consider the alternative path in which the economy remains isolated. Its only route to development is the gradual addition of modern activities that expand the range of goods available and increase the size of the national market, enabling scale economies to be reaped. However, although a fragile state initially has little private capital, the return on private investment may not be high. Returns are dragged down by the inability to reap scale economies and the inability to access inputs that are critical for many activities. It is the combination of scale and interdependence that is the problem. Interdependence alone could be resolved by investing in a miniature version of the global economy. But the economics of Lilliput does not work due to the minimum size threshold required for reasonable productivity in many activities. A corollary is that however abundant and cheap labour might be, capital may be less productive than in the modern global economy.

Consider activities ranked on two criteria: ascending logistical costs of purchasing on the international market, and ascending foregone scale efficiencies if demand is met by local production. In fragile states, many goods and services will be too costly to import yet also too costly to make domestically; hence, they will be unavailable. Non-availability has knock-on effects for domestic production. Virtually all activities have some inputs that are critical to their production. If any of these inputs are unavailable then the activity is domestically unviable. In turn, if the logistical costs of importing this good or service are prohibitive, then it joins the category of goods that cannot be supplied.

The distinctive feature of growth in fragile states is that vast tracts of economic activities that are normal in larger economies are missing. As a result, the growth process is mainly driven by the addition of new activities. By definition, the addition of new activities requires a pioneer investor. If successful, the pioneer both widens the range of goods that are available and increases market size, enabling other firms to reap scale economies. These favourable externalities make further pioneering feasible. If continued growth to the stage of becoming a modern economy is feasible through such a process, and it may not be, it is by means of a sequence of additions to the range of activities achieved by successive pioneers. The growth rate of a fragile state is therefore dependent upon pioneer investors.

The sequence in which activities were accumulated was a concern of an early literature in development economics that analysed import substitution through ‘backward and forward linkages’. A market-driven selection of investments will start with the production of final consumer goods and progress to their inputs – the process of ‘backward linkages’. For example, in South Sudan one of the very few modern economic activities is a brewery. In the context of small markets, development through backward linkages typically runs out of steam rapidly. There may be no viable backward sequence, in which each new investment is privately profitable, that develops a modern economy of sufficient size productively to absorb the labour force. However, from the perspective of the

social planner (who internalises the externalities of interdependence), sequences involving some 'forward linkages' may be more efficient – initial losses suffered by one activity may be more than offset by subsequent gains in other activities. While market-based sequences necessarily ignore externalities, the record of development planning is also discouraging – the enhanced scope to internalise externalities is offset by the scope for political abuse of investment decisions. If public intervention in the investment sequence is envisaged, then some principle must be adopted that bounds the errors.

Since the sequence of private investment is from final consumer goods backwards, those investments that leapfrog to produce those inputs that anticipate demand will depend upon public finance. This has implications for the return on both private and public investment. Despite the small private capital stock, the return on private investment would not be high. Assuming that capital markets were sufficiently integrated internationally, the return might be equated with that elsewhere, but this would occur at a modest level of investment. Similarly, despite the lack of public capital, the return on public investment would initially be below that on private investment: public investment would be leapfrogging into activities that would only subsequently generate an adequate return. That is, the rate of return would be low but would rise with the level of development. A recent empirical study by the IMF, which attempts to estimate the rates of return on private and public capital country by country, finds just this pattern (Lowe and Papageorgiou, 2012). The return on private capital appears to be fairly equal across different levels of development, which is consistent with the idea that despite there being very little private capital in fragile states, its scarcity does not imply high returns. Worse, they find that the return on public capital is very low in poor economies although it rises with development, becoming markedly higher than that on private capital.

The distinctive prominence of the pioneer role in the growth process in fragile states matters because the impediments to pioneering are significantly more severe than to the entry of new firms into already established activities.

2.2. Pioneer investors in fragile states and information externalities

Pioneers face high costs of information. Firms that pioneer activities where the product or services is initially missing (the fourth category) face two gaps in information: the extent of the domestic market, and the costs of domestic production. Those that pioneer activities where the product is initially imported at high cost also face the second of these costs, but not the first.

Both types of pioneer lack the information that is normally inadvertently revealed by the presence of existing enterprise: the activity must be commercially viable. The unknown is normally whether the new entrant will be competitive with the existing entrants. Conversely, all pioneers have the information that the absence of any existing enterprises may indicate that the activity will prove to be unviable. In developed countries, pioneer activities are defined in terms of the product or service produced. New products and services are difficult to assess and so costly information is generated through market research. Even so,

many new products and services fail. In contrast, in fragile states the frontier is not defined by the novelty of the product or service, since this is invariably standard in more developed economies. Rather, it is defined by the local context – an enterprise needs markets for its inputs and outputs. Its viability will also be affected by the costs of transactions, the extent of regulatory impediments and distinctive aspects of local geography.

In a fragile state there is no automatic supply of pioneer investors. Such investment faces impediments that are an order of magnitude more severe than those facing investment in established activities. Pioneer investors are either local firms experimenting with a new product or service, or international firms experimenting with a new market. I consider these in turn.

By definition, local enterprises are not engaged in the activity and so do not know how to produce it. Nor do they know whether they can sell it. In the case of imported manufactures, knowledge of the market is relatively straightforward: the importer is in a position to understand demand. By extension, products and services that are neither imported nor produced but are genuinely missing pose daunting information problems. In developed countries, sophisticated market research can reduce the information gap, but in frontier markets such research is itself one of the missing services.

Even if a local firm overcomes the obstacle of a lack of information about both the market and production methods, it will need to raise the finance for a high-risk investment. Financial markets in frontier economies are among those activities that are highly truncated, so that the supply of high-risk capital for pioneering enterprises is very limited. Essentially, firms will need to self-finance. Yet there are few large domestic firms, and so few firms have the scale of internal risk finance needed for pioneering.

Now consider international enterprises that are already experienced in the activity. The obstacle facing these enterprises is a lack of knowledge of the local context of markets for inputs and outputs, infrastructure, transactions costs and regulation. Can workers of sufficient calibre be recruited at a viable wage rate? Will new suppliers enter the market to provide the firm with critical inputs? Will logistical choke points such as ports be reliable, or will they attract rent-seeking hold-ups? Will buyers be willing to rely upon this new source of supply? Do employees face dangers for which the firm will be held responsible? The only reliable way to get all this information is to undertake the investment. If the enterprise fails, then the value of the investment will decline catastrophically. The enterprise itself will have been demonstrated to be unviable, and also the markets in second-hand equipment and buildings will be very thin. Further, the firm is unable to limit its losses to its investment. To establish the enterprise, the firm will need to send its own staff to work in it, and the firm faces the potential liability of any harm that may befall them.

At the core of the problem of pioneering are the difficulties created by the interdependence of activities. If one activity is unviable then all the downstream activities that are dependent upon it are also unviable. This creates a chicken-and-egg problem: the lack of demand for an input makes its supply unviable, yet

the lack of supply of the input makes demand for it unviable. Where this obstacle is simply a matter of a single bottleneck input needed by a single downstream firm, the coordination problem is not particularly daunting. A new entrant can coordinate its decision with its supplier; for example, even in a thick-market developing economy such as China, Swedish firms that offshore production to meet Chinese demand arrange for their Swedish suppliers to relocate with them. Alternatively, a firm may opt for vertical integration, doing in-house tasks that under conditions of thicker markets would be bought in. For example, James Berger – a German company which is the largest construction firm in Nigeria (also a thick market by the standards of most African economies) – not only operates its own transport fleet, but also retreads the tyres used by its lorries rather than buying in retreading services from other firms.

A corollary of a lack of information and the inability to coordinate across multiple actors is an inability to estimate risk. Until there is a population of firms in the pertinent context (infrastructure, markets and policy), then risk cannot accurately be assessed. If risks cannot be known then they are liable to be exaggerated. The primary purpose of information about risk is to place bounds upon it. In the absence of information, risks cannot be bounded and so in standard commercial decision processes, such as an approvals committee, they must be assumed to be very high. Unknown risk (i.e. uncertainty) is treated qualitatively differently from known risks. Without a procedural distinction between risk and uncertainty in decision processes that penalise uncertainty, approvals committees would not be able to provide an incentive for due diligence by those responsible for preparing a project. Decision rules are adopted that are equivalent to exaggerating the risks that are actually faced.

The key information needed to assess the risks of pioneering cannot be generated other by actually doing the project. This is because the key information is not technical but commercial and so can only be generated by actually trying to run an enterprise. If there is currently no such enterprise in the country (or locality), then pioneer enterprises will generate information externalities for subsequent entrants. Since subsequent entrants will face lower risks, they are also likely to have lower costs (as risks to equity owners will have to be compensated). Hence, the pioneer can anticipate that if the investment is successful, margins will be squeezed by competition that takes advantage of the information it inadvertently generates. While the pioneer generates positive externalities for subsequent entrants, they generate negative externalities for the pioneer. In pioneering, any first-mover advantage may thus be more than outweighed by information externalities.

3. Implications for aid to fragile states

The process of economic growth is driven by entrepreneurs taking investment risks with other people's money. This is happening in most developing countries, but not yet on a sufficient scale in fragile states. Above I have suggested that this is inherent to small, isolated markets. Despite the lack of capital, returns are depressed by the inability to reap scale economies and the absence of

necessary inputs, and risks are elevated by the lack of information facing pioneers. The public sector cannot substitute for the role of entrepreneurs as it lacks the combination of information, incentives and skills that makes entrepreneurs pivotal to the growth process. If public activity cannot substitute for entrepreneurship, should it actively induce entrepreneurship by subsidy, or should it simply provide an 'enabling policy environment'? More specifically, should development assistance be used to subsidise private investments in fragile states?

The core critique of such a policy is that if the project is commercially viable without aid, then the aid is wasted since it would happen anyway, whereas if it is not commercially viable without aid then it is distorting, luring private investment into activities where returns do not warrant it. The fundamental response to this critique is that private investors and donors legitimately have different objectives. The decision problem facing private investors is to allocate capital globally in such a way as to maximise risk-corrected returns. The objective of donors is to promote the convergence of poor countries to the living standards of the developed economies.

In the absence of aid to subsidise private investment, fragile states may not be able to develop. It is entirely possible that the returns on private investment are never sufficiently high to offset the low returns on initial investment. The market solution to the low productivity of people living in fragile states is likely to be for their populations to emigrate, rather than for capital to flow in. Yet the donor may decide, entirely reasonably, that the right social objective is not to maximise the returns on capital but to develop the society *in situ*. The depopulation of South Sudan is not an acceptable solution to its problem of poverty. Hence, the same investment can potentially be bad from a private perspective but good from a public perspective. Since neither the donor nor the government can substitute for private entrepreneurship, if aid is to assist development in a fragile state it must somehow induce private investment.

Option 1: Aid to address isolation

If isolation is the problem, the most direct use of aid to address this would be for it to finance connectedness by investing in transport infrastructure. As transport costs fall and the economy becomes integrated into the modern global economy, it becomes able to follow the normal pattern of development of gradual economic diversification. However, while infrastructure is necessary to solve the isolation problem, it is not sufficient. Two other factors need to be addressed: complementary government services and cooperation with neighbours.

Typically, more of the time costs of transporting goods to and from fragile states are accounted for by bureaucratic delays than by the slow speed of travel. The delays are deliberate, designed to extract rents from users. Unless this is addressed, improved infrastructure will merely increase the rents that officials can extort for granting permission to transport goods, rather than reducing transport costs. The persistence of bureaucratic corruption at choke points in transport, such as ports and roads, reflects the political power of rent-seeking.

If the governments of fragile states want their economies to break out of isolation, there is no alternative to confronting these powerful lobbies. Once an infrastructure investment has been made by a donor, it cannot be reversed. This creates the potential for a *time-consistency* problem: a weak government has an incentive to promise to face down the lobbies, but once the donor has made the investment it reneges on its commitment. Since donors can anticipate the risk that a huge investment in transport infrastructure will prove fruitless, they are discouraged from making the investment. The simplest solution to this problem is for the government of a fragile state to face down the lobbies decisively in advance of seeking donor investment in transport infrastructure.

Given that Africa is divided into 54 states, it is inevitable that much transport infrastructure will be multi-country corridors. For such infrastructure investments, the underlying cause of isolation may be a lack of coordination or cooperation among neighbouring governments. Coordination and cooperation is needed not only to build infrastructure, but also to operate it. The efficient functioning of multi-country infrastructure requires the continuing cooperation of all governments: this exposes the investor to a weakest link problem. Further, since any single government can make the investment unproductive, each can potentially exploit the power of hold-up: once the investment has been made, the investor is powerless to prevent the returns which justified it from being captured by a government. In combination, these features make multi-country infrastructure investments severely *time-inconsistent*: that is, once the investment has been made, each government has a strong incentive to renege on the terms agreed with other governments and the investor *ex ante*. Since both investors and governments can recognise this problem in advance, the result is that such investments are not made because they are too risky. The only solution to a time-consistency problem is for the governments concerned to build a credible *commitment technology*. In the previous time-consistency problem discussed above, where domestic rent-seeking lobbies such as customs officers were the source of the risk, the credible commitment technology was straightforward: defeat the lobbies in advance. However, in the present case the risk comes from the potential for opportunistic behaviour by governments themselves. A commitment technology can thus only be credible if it can create penalties for governments that renege on an agreement which are sufficiently potent that reneging is no longer attractive. The agreement can thereby be trusted by all parties. To date, African governments have not been able to design arrangements that are sufficiently credible to warrant the huge investments that multi-country transport corridors would require. However, the AfDB is well placed to create commitment technologies both because it is a trusted party (African-run but neutral between governments) and because, by virtue of its pan-African long-term lending programme, it can impose and enforce substantial penalties.

Even if transport infrastructure is financed by donors and enabled to operate free of rent-seeking, it is still only one necessary condition for breaking isolation. Many of the costs of transport are endogenous to the size of the market, rather than to the provision of infrastructure. For example, while airport infrastructure is

necessary for air connectedness, the network of air routes depends upon what the market will bear. Hence, like other costs, the reduction in transport costs depends upon growth in the overall size of the market. Isolation is reduced consequent upon growth, but this does not prevent growth being stymied by isolation. An implication is that other donor support for private sector development, discussed below, complements investment in transport infrastructure in gradually breaking isolation.

Governments of fragile states will often need donor finance for major transport infrastructure, but currently some of them have an alternative. In many fragile states there have recently been significant mineral discoveries. Such discoveries can create an opportunity for breaking isolation because the infrastructure needed to transport minerals to the global market can also serve other uses. Typically, mining companies prefer to have dedicated usage of their transport infrastructure – their core mission is extract ore not to run a freight service for other users. Hence, it is important that governments require mining companies to design and operate their transport investments as multi-user facilities (Collier, 2011). Since this will somewhat increase the cost of the infrastructure to the mining companies, there should be an offsetting reduction in taxation. However, the cost to the government in somewhat lower tax revenues is likely to be small relative to the gain to the economy in breaking isolation. If done at the design stage, the extra costs of making transport infrastructure multi-user are far lower than the full cost of building infrastructure from scratch.

Option 2: Aid to subsidise infrastructure

In fragile states, private investment will be disproportionately pioneering. Pioneer investment generates beneficial externalities and so warrants public subsidy. The least complicated way of subsidising such private investment may be indirect – by investing donor resources in infrastructure investments which are not privately viable but which are complementary to much other activity, such as electricity generation, donors raise the return on other types of private investment. The limited extent of private investment in such infrastructure in fragile states suggests that private returns are too low to attract investors. For example, it is notable that to date, despite two decades in which the private provision of electricity has become common both in the OECD and in converging economies, there are no full instances of it in Africa (Eberhard *et al*., 2011).

While the above has been cast in terms of rates of return on investment, it could equally be presented in terms of risk. For a private investor with a portfolio of options, investment in a high-risk fragile state can be overall risk-increasing and so unattractive. However, the objective of the donor is to develop the country, so the key risk is that it may not develop. *An investment that makes development more likely, even if it is risk-increasing from the perspective of a private investor, is risk-reducing from the perspective of the donor.*

However, donor provision of infrastructure may not raise the returns on private investment in fragile states sufficiently to induce a substantial response. After all, many fragile states had better infrastructure at the time of independence

than they do now, but that infrastructure did not induce private investment. As I have argued above, such a lack of private investment in a fragile state may reflect a coordination problem. The growth process depends disproportionately upon the diversification, or broadening, of economic activity and this is more impeded by market failures than the expansion of existing activities. Growth-promoting aid policies may therefore need to pump-prime diversification, much as in OECD economies governments have generated huge benefits from pump-priming technological innovation (Mazzucato, 2013). The analogy is warranted because in each case, the externality of pioneering occurs together with severe information-based impediments to pioneering. Viewed from the perspective of a benign and omnipotent social planner, the return on capital may be maximised by accepting a sequence of investment into fragile states such that the pioneer investments make losses. These investments increase market size and widen the range of available goods, thereby opening up subsequent opportunities for high-return investment. The rationale for donor subsidy of pioneering investment is to substitute for the coordination missing in the private allocation of capital.

This raises the question of whether it is practically feasible to subsidise pioneer investment directly in fragile states. I now consider three potential donor instruments for subsidising pioneering investment: providing capital at below-market rates, providing insurance, and actively partnering on the management boards of enterprises.

Option 3: Subsidising capital

The provision of capital at below-market rates can be through equity or bonds. The former has the advantage of being explicitly risk-bearing and so forces a management decision that evaluates the value of the underlying proposition, whereas the provision of bonds encourages a managerial approach focusing on collateral. The latter is akin to the approach that has been taken by commercial banks in making loans, but since pioneer investment unavoidably puts capital at risk, insistence upon collateral precludes the finance of such investments. However, for donors to be able to evaluate the underlying business case for pioneering ventures, they need a different skill set from that found in the conventional development agency. They need two distinct skills: those of a venture capitalist, able to assess the proposition and management capabilities of a venture (and sometimes strengthen them), and those of a development economist, able to assess the externalities from establishing a new activity for the rest of the economy. In principle, this combination already exists both in the private finance arms of the development agencies such as IFC, FMO and CDC, and in the rapidly growing social enterprise sector. In practice, neither has worked well for pioneer investment.

The public agencies have usually not succeeded in integrating commercial and economic criteria because their investment arms are not financially integrated into their aid budgets. In respect of pioneering investments, there is a straightforward tension between commercial and economic criteria: pioneering investments generate externalities that benefit society but not the venture itself. The core role

of public finance in promoting private investment in fragile states is to absorb the cost of these externalities. Yet in the investment arms of the public agencies, the commercial criteria currently take precedence because the overall private return on the portfolio remains an important criterion of their success. In contrast, the economic criteria have not been integrated into a broader country-specific development strategy, notably one that treats subsidies for pioneer investment as a component part of overall donor support for a fragile state. For example, there is no mechanism whereby part of the IDA allocation for a fragile state can be channelled through IFC to subsidise the externalities of pioneer investments. As a result, the economic criteria have not been sufficiently potent to override the commercial. An inevitable consequence is that fragile state investment in general, and pioneer investments in particular, has made up only a small proportion of the portfolios of the investment arms of the development agencies.

In principle, social enterprise is to private charitable finance what the investment arms of the development agencies are to public development assistance. However, in practice social enterprise has been more interested in the potential of microfinance to alleviate poverty than to support larger-scale pioneer investors through skills and money. Paradoxically, the sector has also mirrored the concern of the public agencies with commercial criteria: an accepted mantra is that social enterprises must rapidly become financially self-sustaining. As with the public agencies, this precludes absorbing the cost of externalities.

Thus, at present neither the donor agencies nor social enterprise provides significant institutional mechanisms for financing the externalities that are likely to be important in the development of fragile states.

In principle, governments themselves can subsidise pioneering investment. Collier and Venables (2012) suggest how this can be done in the special case of pioneering commercial agriculture, but since the approach relies upon the allocation of abundant land as an incentive it cannot be generalised beyond this particular sector.

Option 4: Providing political risk insurance

Donors also provide insurance through agencies such as OPIC and MIGA. As with the capital-providing public agencies, they face the challenge of integrating commercial and economic criteria, and are not financed on the basis that they can make overall commercial losses offset by social gains. For example, MIGA has not been well integrated into World Bank country strategies: there is no mechanism whereby an IDA allocation to a fragile state can in part be used to subsidise the provision of insurance to private investors. As a result, insurance portfolios, like capital portfolios, are skewed away from the countries where they would be of most social value.

Where the public insurance agencies have had remarkable success is with political risk rather than commercial risk. Political risk is important in most fragile states, and may indeed be particularly important for pioneer investments since the extent of vulnerability to political predation in a new activity cannot be well assessed. However, it does not provide cover for the purely commercial

risks of pioneering. Indeed, since many of the unknowns in pioneering are unquantifiable uncertainties rather than quantified risks, there is no basis for insurance; they are best borne by equity capital.

The reason why the donor agencies have been able to provide political risk insurance at below-market rates is that the donor relationship provides some leverage. While the extent of leverage has been grossly over-estimated, notably in the attempts to link aid to the adoption of economic and social policies, a more modest link to the honouring of commercial contracts has proved feasible. Donors clearly have both more access to the higher levels of government than have individual investors, and also more scope for recourse. Thus, MIGA is able to offer five aspects of political risk insurance in Africa's fragile states at a premium of little more than 1% of the sum insured. Risk cover through MIGA is so cheap because the agency has been able to recover all but one of the many claims on which it has paid out.

Again, the provision of political risk insurance is something that a government with natural resource revenues might consider, regardless of whether donors are willing to support it. Since private investment would have evident social benefits beyond the return to investors, subsidising insurance against the risks of political violence would appear to be a reasonable use of public money.

Option 5: Donor-business investment partnerships

By an investment partnership, I mean a long-term arrangement between a donor and a firm through which, subject to government agreement, a series of pioneering investments are undertaken in fragile states. The donor provides sufficient aid to make the venture commercially viable, and the firm commits to using best endeavours to make the venture succeed.

In its origins, development assistance often took this form. Bilateral aid programmes competed with each other to provide subsidies for their national enterprises to win contracts. This is the model that the Chinese have subsequently adopted in their aid programme to Africa, but the model is ethically unappealing and has largely been abandoned in Europe, most explicitly so by Britain which legally requires its aid programme to be uncontaminated by ties to commercial interests. This move towards a disinterested rationale for aid as charity also shifted the ostensible purpose of aid from an economic to a social agenda, and from bilateral to multilateral institutional vehicles, which, by their design, could not give commercial preference.

Nevertheless, despite being ethically unappealing, such commercially linked aid has some striking advantages. The riskiness of an investment is endogenous to the context of the contract. If neither government nor the firm knows the other prior to negotiation, nor has reasonable expectations of further deals, then each must presume that the other is liable to behave opportunistically. Hence, the political risks to the firm are objectively high. A donor as partner can reduce these risks in several respects. From the perspective of the government, the donor can acquire information about its national firm much more readily than the government, and can set this particular contract more credibly in the context

of an ongoing commercial partnership. The donor itself is a known quantity to the government, again with an ongoing relationship and with some reasonable presumption that the donor is indeed looking for deals that are mutually beneficial rather than being advantageous to the national firm only because they are disadvantageous to the government. From the perspective of the firm, if despite these considerations the government does behave opportunistically at its expense, then the firm can reasonably look to the donor for recourse, and the donor can reasonably pressure the government for it, as demonstrated by the success of the public provision of political risk insurance.

The political risk insurance advantage of investment partnerships is particularly important in the case of infrastructure such as electricity, rail and ports. In addition to the problem of low initial rates of return discussed above, an overarching obstacle to private investment in such infrastructure in fragile states is the hold-up problem. Once the investment has been made, the government has an incentive and the power to require under-pricing of the service. Governments need, but lack, credible commitment technologies to overcome this time-consistency problem. By being a partner to the contract, a donor with long-term relationships with both government and the firm may be able to make them viable. The donor enters into a tripartite partnership with a firm and a government, with each of these other parties having some reason to avoid opportunistic behaviour towards the other, and consequently being able to place more trust in the deal.

Donor partnerships with firms for pioneering investments thus package together the instrument of subsidy and the instrument of partnership. The instrument of subsidy is needed to compensate for the externalities generated by pioneering; the instrument of long-term partnership is needed to address the endogeneity of risk to the contractual context.

Such commercial aid also has political advantages. Because the underlying venture is designed to be mutually advantageous other than for the aid subsidy, it is not structurally patronising, which is an unavoidable problem with charity, nor is there an asymmetry of power to be exploited through conditions favoured and imposed by donors (whether economic, environmental, social or political). Viewed from a global perspective, because donor societies benefit to the extent that their aid gains them contracts, competition between bilateral donors would drive aid budgets up, in contrast to the global public good characteristic of multilateral charitable aid which induces free-riding.

4. Conclusion

The future of donors is in fragile states – that is where they have the potential to be strategically important. In this chapter, I have suggested a range of new approaches by which donors could help to break the isolation that traps fragile economies in poverty. By making aid in fragile states more effective, such approaches would also induce an increase in the volume of aid. Currently, donors face an unmanageable dilemma: a tradeoff between providing aid to those countries most in need, namely fragile states, and providing it to those

countries in which aid is most reliably effective, namely those that face fewer problems.

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16

Supporting Risk Management by the Poor: What Role for Overseas Development Assistance?

Alain de Janvry and Elisabeth Sadoulet

1. The efficiency and welfare costs of uninsured risks

Reducing exposure to uninsured risks is important for social progress and political stability, with weather being one of the most important sources of shocks for smallholder farms, the repository for the majority of the world's poor. With a lack of access to formal insurance, self-insurance to cope with shocks is costly to these households and ineffective for covariate risks that cannot be insured through local mutual insurance. Self-insurance can lead to the decapitalisation of household assets, including the sale of productive assets and the loss of human capital in the form of discontinued child education and malnutrition, compromising future health in an eventually irreversible fashion, particularly for infants. It can also push households into debt with usurers, unwanted migration and the use of child labour as a survival strategy. Self-insurance in *ex ante* risk management is also costly. It leads to a choice of investment strategies with low expected profit in exchange for low risk, costly income diversification, and the accumulation of precautionary savings.

Self-insurance for coping with shocks and for risk management can thus be a source of slow growth and poverty. Reducing vulnerability to shocks and helping countries, institutions and individuals with the financing of coping with shock, risk reduction and risk management is a major, but poorly addressed, issue in development.

2. Instruments for coping with shock, risk reduction and risk management

Effective instruments for coping with shock, risk reduction and risk management by the poor do in fact exist, but are under-provided and under-used. The question is how to secure the delivery of these instruments in a way that achieves sustainable uptake and scaling-up. In this, we identify the potential role of ODA in the delivery of international public goods and the financing of smart subsidies towards the sustainable adoption of risk-related investments. We argue here that this role is under-provided and needs to be addressed in the post-2015 sustainable development agenda. Specifically, we explore three instruments

from which broader lessons can be derived: flood resistant rice varieties, index-based weather insurance, and flexible financial products.

3. Flood-tolerant rice varieties: The role of international public goods

Vulnerability of crops to weather shocks such as flood, drought and temperature extremes can be addressed through technological innovations. New flood-tolerant rice varieties were recently released by the Consultative Group on International Agricultural Research (CGIAR) in collaboration with the National Agricultural Research Systems, in particular in India and the Philippines. Exposure to flash floods affects millions of hectares of rice-growing land and is a major source of crop loss. With these new flood-tolerant varieties, the absence of a yield penalty in normal years secures high effective demand, a major achievement for the adoption of risk-reducing technological innovations permitted by advances in marker-assisted breeding. Under these conditions, risk reduction not only protects yields in flood years, but also creates incentives to invest more in normal years, thus achieving higher yields in those years as well.

Using a randomised control trial in Odisha, India, we show that yields of the flood-tolerant Swarna-Sub1 variety compared to Swarna, the next best variety, are higher for floods lasting from five to 15 days, with no statistical difference for zero to four days of flooding (Dar *et al.*, 2013). With floods lasting ten days, Swarna-Sub1 offers an increase in yields of approximately 45%. These yield-coping effects turn out to be particularly beneficial to the lower-caste farmers who have been pushed toward the most flood-prone lands over centuries of discrimination. We also show that farmers who experienced yield-coping benefits during a flood year engaged in less risk management for self-insurance in all years (Emerick *et al.*, 2014). As a consequence, they plant more rice and achieve higher yields in normal years. This is due to use of transplanting instead of broadcasting techniques for seeding, and to the application of more early fertilizers. Improved capacity to cope with shock also induces less use of precautionary savings in the form of grain reserves and more use of agricultural credit. This is a major achievement, and perhaps an unexpected one for the agricultural scientist who focused flood-resistance research on the avoidance of yield losses in bad years. We find that yield gains due to improved risk management are of the same order of magnitude as the yield losses due to flood that are avoided. If there are three or four times more normal years than flood years, gains from reduced risk management are equal to the gains from improved capacity to cope with shocks.

Agricultural technology can be a public or a private good, depending on the ability of the innovator to exclude users. Exclusion can be based on the enforcement of patent rights, something that is difficult to achieve in developing countries, or on using hybrid seeds that quickly lose their yield superiority and need replacement. Because the current flood-tolerant varieties are open pollinated, farmers can reproduce the seeds once they are available to them, preventing exclusion after they have been released. This limits the interest of the

private sector in providing these seeds until the genes are transferred to hybrids with superior yield performance. The availability of flood-tolerant technology is thus a global public good, and like all global public goods, it suffers from under-provision due to lack of global governance. As opposed to national public goods, where governments can assume the role of provider, there is no mechanism here to manage collective action, internalise externalities and coerce free-riders into participating (Nordhaus, 2005). International agreements can be put into place to secure these goods, but rules can only be imposed on a government with its consent. Unanimous voluntary participation would be needed to secure optimum provision, a condition that is unlikely to apply, especially if there are strong asymmetries across nations in the incidence of costs and benefits.

The CGIAR has been created to secure the provision of agricultural technologies that fit into the category of international public goods. Its optimum funding would require the participation of all governments and unanimous decision-making, which is certainly not the case – only a few governments have become members of the CGIAR. As a consequence, ODA has picked up some of the slack. Studies have consistently shown that investment in CGIAR research has a very high rate of return, making it one of the jewels of ODA. Raitzer and Kelley (2008) estimate a benefit-to-cost ratio of 17 by charging all CGIAR costs against the benefits of just three of the most successful technological innovations: biological control of the cassava mealybug, breeding of Spring bread wheat, and modern rice varieties. But high returns on investment, above the opportunity cost of capital, also indicate that there is under-investment in research and development for agriculture. Free-riding among donors must be overcome to generate the necessary budget for international public goods such as flood-tolerant rice varieties. The other issue is that each donor wants to fund particular projects in which it has a special interest. While all agree that core funding for the CGIAR would be more effective, there is free-riding on core funding, resulting not only in overall under-funding, but also inadequate funding in terms of project allocation.

4. Index-based weather insurance: The role of smart subsidies

Formal insurance should be the main instrument to reduce exposure to risks that are not more advantageously self-insured or mutually insured against. This is particularly the case for large covariate weather shocks. It is, however, well known that conventional insurance contracts based on indemnity payments against verifiable losses are not workable for small farmers in developing countries (Hazell, 1992). They induce perverse behaviour in selection and risk-taking, and are prohibitively expensive to implement. For this reason, institutional innovations in micro-insurance have been sought to make formal agricultural insurance available to smallholder farmers (Carter, 2009). This has led the profession to propose index-based weather insurance as a workable product. In this case, insurance payouts are triggered by observable weather indicators at the level of the most closely located meteorological station, and are delinked from

events at the individual farm level. This does not induce perverse behaviour and is cheap to implement. Against these advantages, it has the drawback of basis risk, which arises from the discrepancy between measured risks at the meteorological station level and the occurrence of yield losses at the farm of the insured. It may rain at the station, but not in the farmer's field who then suffers a serious drought. And lack of rainfall may not be the main determinant of low yield, the outcome that the farmer wants to insure. In spite of this, if the insurance product is competitively priced and the basis risk is not too large (for example, because there is a dense network of weather stations or remote-sensing measurement of a correlate to rainfall, such as biomass), the uptake should be large. This has not been the case – there has been low availability of index insurance on the supply side, and low uptake in spite of presumed cost effectiveness. There may exist a role for ODA in helping resolve this dilemma. Enhancing uptake requires financial contributions to induce supply and subsidies to enhance demand once the supply is in place.

4.1. ODA-supported supply-side interventions

There are two constraints to offering an index-based insurance product that ODA may help overcome. The first is that there are large fixed costs in product design and information. This implies that providers have a declining average cost function and that a relatively large scale must be reached to offer the insurance product with a low loading over the fair price. This justifies a one-time temporary subsidy to demand to achieve a scale that creates enough effective demand. The subsidy can be 'smart': once the scale has been reached or the predetermined time to reach it has elapsed, it is removed.

The second constraint is lack of long-term time series on weather events and yields for the locations where insurance is to be provided, preventing pricing and especially re-insurance. Because events are typically covariate over large areas, local insurance companies need re-insurance. To assess the insurance product, regulators want an accurate estimate of the relationship between yield and weather. Many potential programmes have run into the bottleneck of a lack of data to satisfy the demands of re-insurance companies and regulators. More weather stations need to be built, but this will not help create the missing historical information. Data can be accumulated as programmes are started, but re-insurance has to be provided as a public good for a number of years. There is a role here for transitory public re-insurance until the data become thick enough for the re-insurance market to work. The cost of public re-insurance can be assumed by ODA as a 'smart' subsidy that will be removed as soon as the necessary data have been accumulated. Because the risks assumed in re-insurance have low probability but potentially involve large payouts, they do not fit well into ODA budgeting. This implies that ODA expenditure flows themselves may need to be insured. We discuss below the Mexican approach to insuring expenditure flows for social protection.

4.2. ODA-supported demand-side interventions to learning and trust

The concept of insurance is foreign to most smallholder farmers, and thus requires learning. Learning about weather insurance is particularly difficult because insured events are rare, and the covariate nature of shocks implies that learning from others is no different from learning by oneself if insured. For this reason, insurance has been described as a ‘credence good’ (Clarke and Wren-Lewis, 2013), that is, a good whose value is only revealed after purchase and where the accumulation of information for learning may take years. Additionally, in an insurance contract, the premium is paid ahead of the event, implying that the client must trust that the insurance company will deliver when adversity strikes. Such trust can only be established by witnessing shocks and payouts in accordance with contracts. To this, index insurance adds an extra layer of difficulty. Because of the lack of immediate correspondence between yield losses at the farm level and climatic events at the station level, index insurance is not easy to understand for clients and requires additional trust over the measurement of the event in a far-off location or through satellite observations of biomass.

Experimental work on the demand for weather insurance shows that learning about the product requires exposure to financial education. This is costly and can be part of ODA. The good thing is that information can circulate through social networks, reducing the cost of financial education if entry points into networks to provide education have been effectively selected (Cai *et al.*, 2014). As for trust in the insurance company, most effective is witnessing payouts made by the insurance company to oneself or to others after an adverse event. Subsidies for trust-building have a role to play in creating a large base of users across diverse environmental environments from which learning can take place. The circulation of information on events and payouts is important, as events are dispersed across space. Links can also be made to the provision of credit or the availability of technological innovations to make insurance more valuable. This important role of learning and trust implies that ODA can make a contribution to the uptake of index insurance. Smart subsidies must be carefully designed and financed to achieve this purpose.

4.3. Sheltering households from catastrophic events

Protection against risks can be layered with differential financial products. Low-intensity and high-frequency weather shocks can be self-insured against through savings and credit. They imply risk retention. Medium-intensity and less frequent shocks can be insured against through commercial index-based insurance, implying a risk transfer. Catastrophic events of high intensity and low frequency can be covered by public insurance. In this case, catastrophic insurance is provided for free as a public good that can be targeted to specific social groups deserving social protection, as is the case with the Cadenas programme in Mexico. This is an index-based insurance for drought covering four basic food crops, of which maize is by far the most important. The insurance is provided by the national public insurance company Agroasemex and co-financed by the Ministry of Agriculture and state governments. Small farmers cultivating fewer

than 20 hectares of land are automatically enrolled in the programme at no cost and are informed of coverage through their enrolment in the farm subsidies programme (Procampo). Given the social obligation to provide public relief to the poor for catastrophic events, the insurance contract with Agroasemex serves as a budget risk-management instrument for government, allowing annual budget planning with reduced risk of extraordinary expenditure should a severe drought occur. For farmers, it serves as a commitment device that relief will come in a predetermined amount in relation to observable index-based shocks. If the commitment is credible, farmers can plan accordingly in reducing costly risk management through self-insurance.

Sheltering households from catastrophic events can allow smallholder farmers to better manage risk, but can the efficiency and welfare effects be large? Fuchs and Wolff (2010) use as an identification strategy the rollout of the insurance programme over time and across municipalities to show that presence of the programme induced a 6% gain in maize yields and a 6-7% gain in per capita annual expenditure for covered households. The benefit-to-cost ratio of the programme was 350%, making it, as with risk-reducing flood-tolerance technology, a highly profitable investment. Improved risk management could include the use of commercial index-based insurance where it is individually available. This experiment in risk layering with index insurance thus has important generic lessons. While middle-income countries such as Mexico can afford to cover such a programme out of fiscal revenues, poor countries could introduce similar programmes with the contribution of ODA.

Weather is not the only source of risk that can bankrupt farmers and keep them in poverty if not insured. Price instability is another important source of risk, and the two sources interact in a way that affects the demand for index insurance. If there is a negative correlation between quantity and price – for example, a demand elasticity of -1 for non-tradable goods on local markets – then the price response fully insures quantity variations (Newbery and Stiglitz, 1981). The market response to weather-induced quantity shocks drives the demand for weather insurance down to zero. At the other extreme, if demand is infinitely elastic with no risk on the international market, the demand for insurance is fully determined by quantity risk. Trade liberalisation in stable international markets thus has no bearing on the demand for weather insurance. If, however, there is both price and quantity risk, and the correlation between the two risks is zero, as one would expect for a small open economy, then price risk increases the demand for weather insurance. With increasing price instability on international food markets following the 2008 world food crisis, this is a significant phenomenon, adding background risk to the demand for weather insurance. Since this is likely most common for developing country agriculture, it gives greater importance to the provision of index-based weather insurance, and to the role ODA can play in helping farmers take up this form of insurance.

5. Flexible financial products for risk management

It may well be that the low uptake of index-based weather insurance is because insufficient attention has been given to risk layering and the need to use other financial instruments for more effective risk retention in facing smaller and more frequent shocks. For these, savings and credit may be most effective, provided that these products are designed to help clients use them to manage risk. To date, in spite of major achievements with microfinance, this is surprisingly still hardly the case.

Microfinance has clearly brought a revolution in terms of enabling the poor to gain access to financial services, especially credit without formal collateral (Robinson, 2001). Encouraging saving by helping individuals to overcome tendencies to procrastinate over saving or to succumb to temptations or social pressures to dissave has also been a major achievement. Initially, these achievements were based on imposing discipline in repayment and on incentives to save and not dissave by using rigid rules. Repayment typically required bi-weekly instalments and group meetings to mobilise social collateral. Savings were linked to borrowing or to the periodicity of wage payments or of regular Rotating Savings and Credit Association (ROSCA) meetings.

With the accumulation of experience, financial products have become increasingly flexible. For customers with good credit records, loan repayment has often done away with the obligation of group meetings and frequent instalments. Repayment schedules have been adjusted to the timing of customers' expenditure and income cycles. In some cases, borrowing is no longer related to specified purposes (such as a pre-defined investment project) and repayment is left fully discretionary, with interest paid on outstanding balances. The Kisan Credit Card offered to farmers by the National Bank for Agriculture and Rural Development (NABARD) in India, the Good Borrower Loans offered by the Bangladesh Rural Advancement Committee (BRAC) to its current borrowers, and the SafeSave scheme in the slums of Bangladesh all have innovative features of flexibility in borrowing and/or saving. Key to this has been ensuring that greater flexibility in repayment was not offered at the cost of discipline, and that greater flexibility in savings was not offered at the cost of lax behaviour. Success in providing more flexible products with no penalty on performance has helped boost both microfinance lending and the benefits derived by customers from microfinance products.

Yet, this flexibility has not been formally aimed at the management of risk. This is a major opportunity that could be the next step in the evolution of microfinance. As it did in supporting the first two phases of microfinance – rigid repayment and saving rules, followed by increasingly flexible products to improve client performance – ODA could make a major contribution to assisting this third phase in the evolution of microfinance towards serving as a risk-layering instrument.

There are three types of initiatives that may need assistance to transform flexible financial products into risk-management instruments: re-insurance, shared information on clients, and availability of capital for lending.

5.1. Re-insurance for emergency credit

The experience with flexible microfinance loans such as BRAC's Good Borrower Loans and the Kisan Credit Card is that they tend to be fully drawn out to gain access to liquidity, leaving no option to borrow to respond to emergencies. If open credit lines are to be used for shock response, their use for other purposes should be limited. A simple approach is to index borrowing to observable covariate shocks, by analogy with index insurance. Indexed emergency loans can thus be credibly committed for selected clients, and access to these loans can enter into their calculus of risk management. One inconvenient aspect of this is that large covariate shocks will imply a commitment to the availability of large liquidity pools. Meeting this obligation through precautionary reserves (risk retention by the lender) would be too expensive. Re-insurance for emergency credit thus needs to be available. The ability of the lender to re-insure runs into the same exigencies as the ability of local insurance companies to re-insure index-based insurance products. Historical data on events selected as triggers must be available to estimate statistical moments. The lack of such data invites public re-insurance during the accumulation of such data, with a potential role for ODA.

5.2. Information sharing on client performance: A role for credit bureaus

Emergency lending is particularly challenging for microfinance lenders, as it is requested by clients at the worst moments in terms of their repayment capacity. For this reason, accurate information on clients' capacity and willingness to pay is essential. Monopolistic microfinance lenders have private information on the performance of their own clients. When competition among lenders rises, this information becomes increasingly insufficient to characterise clients' outstanding debt burdens. This is where credit bureaus for microfinance lenders have a role to play (de Janvry *et al.*, 2010). Bureaus allow reputation to be shared and competitive lending to emerge. Credit scores can be socialised to serve for emergency lending decisions. Yet, experience shows that establishing credit bureaus for microfinance lenders is not easy. Many such lenders have weak management information systems (MIS), and are not readily willing to share information about their best clients with competing lenders. Establishing a credit bureau requires collective action in the industry that calls for a coordinator. Here, there is a significant role for ODA, both in terms of technical assistance and funding of start-up costs. Among the elements of technical assistance is the definition of credit scores that reflect ability and willingness to repay under emergency conditions, and among the start-up costs is the upgrading of MIS and the management of a shared database. As we have observed in Guatemala, investing in these costs has high returns for participating lenders.

5.3. Capital for emergency lending

If loans are to be used to respond to covariate shocks, liquidity must be readily available to lenders for this purpose. This requires access to borrowing for microfinance lenders. Such lines of institutional lending must be pre-approved

to guarantee client service under emergency conditions. This is where ODA can also have a role to play: providing a guarantee that institutional loans will be repaid, like the World Bank guarantee of sovereign debts. Only with access to a risk-related emergency lending market will microfinance institutions eventually be able to specialise in emergency credit beyond a 'good borrower loan' approach that is internal to the institution, as in the case of BRAC.

6. Conclusions

We have argued that exposure to uninsured risks is a major source of slow growth and new or continuing poverty. This is due to both weak capacity to cope with shock leading to the decapitalisation of assets in response to shocks, and the need for self-insurance in risk management leading to low expected returns on investments to achieve risk reduction. We have identified three instruments with a role to play in coping with shock, risk reduction and risk management: weather-resilient crop varieties for risk reduction, index-based weather insurance for risk transfer, and flexible financial products such as savings and credit for risk retention.

We have shown that in all of these cases, there is a role for ODA. This can take the form of global public goods, such as non-excludable agricultural technology. Open pollinated flood-tolerant rice varieties provide a case in point. Given the lack of global governance, international coalitions such as the CGIAR are necessary, and there is a role in funding for ODA. Coasian cooperation is difficult to achieve, however, leading to both overall under-investment and to the misallocation of resources due to freeriding in financing core budgets. Better impact evaluation is needed for donors to engage in results-based management. Room still exists for improvement in donor coordination in supporting what has been one of the most successful experiences in the role of ODA for development.

Another significant opportunity for ODA to support risk management by the poor is in funding smart subsidies in the use of financial products such as index-based weather insurance and flexible savings and credit adapted to risk response. We have seen that there is a large discrepancy between the potential use of these financial products for risk response and the reality. Index insurance has a low uptake and successes are confined to pilot experiments or to permanent subsidies. ODA can help stimulate uptake through one-time subsidies to achieve scale and public re-insurance. On the demand side, learning with a credence good and developing trust with the insurance provider can be supported by smart subsidies. Insuring catastrophic risks as a public good can induce an output response through reduced self-insurance in risk management and the use of commercial index insurance for risks with intermediate levels of intensity and frequency.

Finally, there is the largely unexplored use of savings and credit for coping with shock and for risk management. This requires promoting a third phase in microfinance development towards flexibility for risk response. ODA played an important role in the promotion of microfinance during its first two phases. Re-insurance of credit lines, setting up credit bureaus for information sharing on

client scoring for risk, and access to institutional funds for emergency credit are all high payoff opportunities for ODA support for this new phase of microfinance.

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Financial Deepening and Poverty Reduction

Sylviane Guillaumont Jeanneney and Kangni Kpodar

Introduction

The development of financial systems goes hand in hand with economic development. It takes the form of expansion and diversification of financial assets and financial institutions, which is known as 'financial deepening'. There is a large literature on the two-way relationship between financial deepening and economic growth. However, there is little in the way of research on the role played by financial development in poverty reduction.

This chapter focuses on how the financial system contributes to poverty reduction in developing countries, and especially low-income countries. It is argued that financial development has a positive effect on the income of the poor: (i) indirectly if it stimulates economic growth, which is in itself favourable to the poor; and (ii) directly if it enables the poor to access financial services. These two channels are considered in turn.

1. Finance, growth and poverty

1.1. Finance and growth

Although the relationship between financial development and growth continues to fuel debate, most authors consider that by and large, financial deepening has a favourable impact on economic growth; the literature also acknowledges that economic growth can itself stimulate financial development. For empirical studies, this double causality raises the challenge of the endogeneity of the variable measuring financial development.

Theoretical arguments

The debate began very early with the work of Schumpeter (1912), Gurley and Shaw (1960), McKinnon (1973) and Shaw (1973). In 1912, Schumpeter highlighted the essential role of banks in financing innovative businesses and increasing productivity. As for Gurley and Shaw, they note the importance of financial innovation for economic development as it facilitates better risk management and a reduction in intermediation costs. However, certain disappointments stemming from the financial liberalisation policies that were strongly supported by McKinnon and Shaw at the beginning of the 1970s

cast doubt on the potential benefits of finance for growth. It was only in the 1990s that a resolutely positive view of the impact of financial development on growth re-emerged with the studies of King and Levine (1993a,b,c) and Levine (1997). According to these authors, financial intermediaries stimulate capital accumulation and an increase in factor productivity by performing five functions: (i) acquiring information about projects and allocating resources to the most profitable projects; (ii) facilitating the trading, hedging, diversification and pooling of risks; (iii) monitoring managers and exerting corporate control; (iv) mobilising savings; and (v) facilitating the exchange of goods and services.

What do the empirical studies say?

Beyond the theoretical models,[1] a burgeoning empirical literature has shown that financial development does indeed encourage economic growth. Levine *et al.* (2000) carry out a cross-sectional and dynamic panel analysis to econometrically test the link between financial development and growth, while attempting to correct endogeneity bias. The results from a sample of 74 countries at all stages of development, with data covering the period 1960-1995, indicate that the exogenous component of financial development[2] has a considerable positive impact on economic growth[3] after controlling for the influence of its other determinants (such as initial GDP, the rate of inflation, government consumption, openness to trade, the black market premium and political instability). The results also show that the positive effect of financial development on growth stems more from total factor productivity than from capital accumulation. Beck and Levine (2004) expand on this work by including stock markets. Their study, which was carried out on a sample of 40 countries with panel data averaged over five-year periods between 1976 and 1998, suggests that the development of banks and the development of financial markets each independently has a positive effect on economic growth.[4]

However, some studies have cast doubt on the strength of the positive relationship between financial development and growth, though their conclusions vary and are difficult to reconcile. Fernandez and Galetovic (1994) and De Gregorio and Guidotti (1995) claim that the relationship between financial development and growth becomes non-significant as the level of per-capita income increases. In addition, Favara (2003) shows that development of

1 See, for example, Greenwood and Jovanovic (1990), Bencivenga and Smith (1991), Saint-Paul (1992) and King and Levine (1993b).

2 Financial development was measured by the ratio of liquid liabilities (M3) to GDP, the share of commercial bank assets in total financial sector assets, and the ratio of private sector credit to GDP.

3 The use of firm data has led to the same result (see Rajan and Zingales, 1998).

4 Another part of the literature debates the causality between financial development and growth. The empirical results are very varied, ranging from no causality, to causality in one direction or the other, to dual causality (see, for example, Arestis and Demetriades, 1996; Luintel and Kahn, 1999; Christopoulos and Tsionas, 2004). There is also a debate about which financial system structure is most favourable to economic growth. Bank-dominated financial systems and market-dominated systems both have advantages and disadvantages, and empirical evidence has shown that controlling for the level of financial development, there is no significant difference between the two systems in terms of their contribution to growth (see Demirgüç-Kunt and Maksimovic, 2002; Levine, 2002).

a financial system only influences growth during the intermediate stages of its development. It may therefore be the case that there are threshold effects or non-linearity in the relationship between financial development and growth, a theory that has been highlighted by some authors (Deidda and Fattouh, 2002; Rousseau and Wachtel, 2002; Rioja and Valev, 2004; Arcand *et al*., 2012).[5] Furthermore, the relationship appears to vary from one continent to another. For instance, De Gregorio and Guidotti (1995) assert that when the sample is limited exclusively to Latin American countries, the impact of financial development on growth is significantly negative.[6] Andersen and Tarp (2003), on the other hand, find a non-significant but negative impact for sub-Saharan African and Latin American countries.

The diversity of the results and the contradictions that stem from this can be explained by statistical factors such as differences in the samples of countries considered, the time period of the studies, the econometric techniques used, data variability and the limits of the financial development indicators used. More fundamentally, however, the complexity of the relationship between financial development and growth is another source of these discrepancies. The relationship between the pace of financial development and its instability is an essential aspect. Excessively rapid growth of deposit money and the growing complexity of financial instruments without adequate oversight and regulation of banks lead to excessive risk-taking by banks, which can weaken the stability of the financial system. Furthermore, competition between banks, which is supposed to help lower transaction costs, can be counterproductive if it reduces the incentives for banks to develop long-term relationships with businesses and to invest in information seeking.[7] Guillaumont Jeanneney and Kpodar (2006a; 2006b) have shown that financial development can be a source of financial instability, especially when inflation is high and institutions are weak. This instability dampens the favourable effect of financial development on growth, albeit without cancelling it out. Their estimates are based on a panel of 121 developing countries over the period 1966-2000 and suggest that the positive effect of financial development on economic growth is reduced by about 45% due to the financial instability that it causes. It is therefore not surprising that when financial crises occur, as in Latin America during the 1970s and 1980s, the relationship between the development of the financial system and growth becomes negative. However, in the long term, this negative effect can disappear. Loayza and Ranciere (2006) show that a long-term positive relationship between financial development and growth coexists with a short-term negative relationship due to financial crises.

5 For a recent review of the economic literature on the relationship between financial development and growth, see Panizza (2013).

6 Ram (1999) and Luintel and Khan (1999) reach similar conclusions with more geographically diversified samples.

7 For example, banks can be induced to raise creditor interest rates to keep or attract deposits, but maintaining their margins requires high-yield investments, which are often also the riskiest. The moral hazard created by an implicit state guarantee in the event of a bank collapsing can reinforce this behaviour on the part of banks.

The favourable impact of financial development on growth (which does appear to be the most common situation) is the first channel through which it contributes to poverty reduction. But growth increases the income of the poor to varying degrees in both absolute and relative terms, according to its characteristics and the inequalities that it creates.

1.2. Growth and poverty: Unitary elasticity?

Interest in studying the empirical relationship between growth and poverty was stimulated by Dollar and Kraay (2002), who suggest that there is a unitary relationship between the increase in the average income of the population and that of the poorest 20% of the population.[8] In other words, the poor benefit from growth as much as the non-poor on average. The authors also suggest that several important determinants of growth have no effect on the proportion of income of the poorest 20%.[9] These include education and healthcare spending and agricultural productivity – factors which are generally assumed to benefit the poor – as well as financial development. The latter result is challenged in the second half of this chapter. Dollar *et al.* (2013) reiterate these conclusions and even extend them to the average income of the poorest 40%. Of course, the conclusion regarding a unitary elasticity of the average income of the poor with respect to growth has drawn many criticisms due, in particular, to (i) the lack of a theoretical framework underpinning the empirical analysis; (ii) the fact that this unitary relationship does not necessarily imply that the poor derive the same benefits from growth as the non-poor inasmuch as, in absolute terms, their average income increases by less than that of the non-poor;[10] (iii) the heterogeneity in the data, which means that although the poor benefit from growth on average, not all of the poor benefit from it in the same way;[11] (iv) the approximation of the poverty data taken from surveys, which can compromise the reliability of the results; and finally v) the fact that the result, although valid for the average, deviates from the latter depending on the country. With regard to financial development, we believe that the more or less pro-poor nature of finance-driven growth can be shaped by the characteristics of financial development itself.[12]

Characteristics of finance-led pro-poor growth

The allocation of loans across sectors plays a role in the impact that growth can have on the poor. Growth benefits the poor less if loans are channelled into sectors from which they draw little or none of their income. In many developing countries, agriculture accounts for a large proportion of GDP, but in terms of loan

8 The sample used covers 92 countries at all levels of development with data spanning four decades.

9 Policies aimed at stabilising inflation and reducing public spending appear to benefit the poor marginally.

10 Ravallion (2001) notes that the increase in income for the wealthiest decile in India was four times greater than the increase for the poorest quintile. In Brazil, the increase in income for the wealthiest decile was 19 times greater than the increase for the poorest quintile.

11 Bresson (2010) has underlined that the growth elasticity of poverty is itself subject to great heterogeneity, depending on the functional form assumed for income distribution.

12 We consider that growth is pro-poor when the increase in the average income of the poor is greater than the increase in average income.

allocation this sector remains marginal, and the great majority of the poor live in rural areas. For example, in the countries of the West African Economic and Monetary Union (WAEMU), the agricultural sector contributes approximately 40% of GDP on average but receives less than 10% of private sector credit (Kpodar and Gbenyo, 2010, p. 25). Similarly, where loans go mainly to large enterprises rather than to small and medium-sized enterprises (SMEs), which create more jobs, the impact that finance has on the poor through growth is lessened. The lack of access to finance limits the growth of firms, particularly that of SMEs (Beck *et al.,* 2005, 2009; Banerjee and Duflo, 2014). In addition, according to Beck *et al*. (2009), the development of financial markets increases competition between market finance and bank finance, and this benefits large enterprises. However, this competition can also benefit small enterprises where it spurs banks to turn towards SMEs to penetrate new markets.

Another aspect is the duration of loans granted to businesses and their suitability for the latter's needs. To expand their production capacities, businesses need short-term and long-term loans. Due to the risky macroeconomic environment, the weakness of institutions and the absence of long-term funds for banks in some developing countries, banks prefer short-term commitments. This lack of long-term loans is especially problematic for SMEs, which do not have access to the financial markets. For example, Kpodar and Gbenyo (2010) have shown that in WAEMU countries, 70% of bank loans to the private sector are short term.

Finally, financial development makes growth less pro-poor insofar as it creates financial instability. On the one hand, the poor appear to be particularly affected by financial crises. It is they who suffer most when banks collapse. When deposits are frozen, they cannot fall back on monies placed abroad. When banks are in difficulty, they initially reduce the availability of less profitable small loans, and hence loans to SMEs. On the other hand, because investment is closely linked to financing conditions, financial instability exacerbates fluctuations in investment and undermines growth. In addition, financial instability causes instability in the real exchange rate, as the prices of tradable goods are determined on the international markets whereas those of non-tradable goods depend on domestic supply and demand and are therefore directly affected by fluctuations in bank loans. In short, instability of the rate of investment and the real exchange rate makes growth unstable (Guillaumont Jeanneney and Kpodar, 2011). In addition to the negative direct impact of financial instability on the poor, instability of growth is also unfavourable to them. It results in low long-term growth on the one hand, and asymmetry between periods of income reduction and periods of income growth on the other, because the income of the poor can decrease by more during a period of recession than it increases during a period of growth, especially in the absence of adequate social safety nets. This is because the least educated workers are the first to be made redundant and remain unemployed for longer, which makes it less easy for them to find employment when the situation is reversed. Their income, which is generally not indexed to the price of goods, is especially affected in real terms by the variability of inflation (the last one being therefore unanticipated) that accompanies financial instability.

In summary, financial development is favourable to the poor through its impact on economic growth. This is especially true where finance irrigates the sectors and businesses in which the majority of the poor work and where it is stable. This conclusion helps to explain an idea that is sometimes put forward – that economic growth results in little or no reduction in poverty. This has clear implications for macroeconomic policy.

1.3. A pro-poor macroeconomic policy

Since the beneficial effect of financial development is lessened by the financial instability that often accompanies financial development, economic policy should take this into account. This is valid for both low-income and emerging countries. In the case of the former, banking crises generally result from the inability of the monetary authorities to properly regulate the banking system, and in the case of the latter they result from the volatility of international capital flows in the context of a high degree of financial openness. In either case, excessively expansionary monetary and fiscal policies exacerbate the fragility of financial systems. A large increase in the money supply leading to inflation, a high degree of trade and financial openness in economies which are vulnerable to external shocks, and poor enforcement of the rule of law and international standards in relation to business and bank accounting are factors that are conducive to a financial crisis. Consequently, policies that aim to expand financial intermediation must be accompanied by macroeconomic stabilisation policies, gradual or controlled opening-up and adequate regulation and supervision of the banking system.

2. Pro-poor finance

This now leads us to the direct effects, independent of growth, that financial deepening can have on poverty reduction, which have been highlighted in particular by Beck *et al*. (2007) and Guillaumont Jeanneney and Kpodar (2011).

There are many well-known arguments for why financial development may reduce poverty to a greater or lesser extent for a given level of output per capita. After presenting these reasons and empirical evidence indicating that financial institutions have a favourable impact on poverty reduction, we will consider ways of increasing this impact in developing countries, especially low-income countries.

2.1. Why can finance be specifically pro-poor?

Theoretical arguments

Access to various forms of financial services (deposits, payments, bank loans, insurance) is an important means of lifting households out of poverty.[13] Because medium-term and long-term loans enable the poor to invest in new and profitable activities or to fund their children's education, they can be regarded as an essential factor in poverty reduction. However, because of the obstacles to the

13 We do not deal here with financial markets, which are inaccessible to the poor. Development of these markets helps to reduce poverty by stimulating economic growth, but it cannot have a direct impact on the number of poor people.

granting of long-term bank loans, the impact of other financial services must not be overlooked.

As McKinnon underlined in 1973, when economic agents are forced to self-finance, so that savers (households) cannot be distinguished from investors (businesses), indivisibility of investment is a considerable problem. In this case, money and physical capital become complementary. 'If the real return on holding money increases (thanks to a more competitive and more developed financial system), so will self-financed investment over a significant range of investment opportunities. The increased desirability of holding cash balances (for the poor) reduces the opportunity cost of saving for the eventual purchase of capital goods.. The financial "conduit" for capital accumulation is thereby enlarged' (McKinnon, 1973, p. 60).[14]

The fact that the poor could keep their savings in the form of deposits, which protects them from loss or depreciation of their cash, not only facilitates their investments but also enables them to cope with the economic, climate-related and health-related uncertainties to which they are particularly vulnerable. This is especially true for farmers, who have to deal with fluctuations in the prices of agricultural products and variable precipitation. In this context, access to short-term loans (that finance consumption), crop insurance or health insurance services can supplement the guarantee that cash savings provides.

By reducing poverty, financial development reduces income inequality. The most recent empirical analyses support the idea that the reduction of inequalities is favourable to growth (Berg *et al.*, 2012; Ostry *et al.* 2014). There would therefore be a virtuous circle stemming from the effect of financial development on the reduction of poverty and inequalities, which would in turn stimulate growth, itself a factor in reducing poverty (see Section 1).

The reality

In developing economies, the poor access banks or microfinance institutions more through deposits than loans. In 2011, on average 25% of the poorest quintile of the population had a deposit account and only 8% took out loans from those institutions compared to 30% of all adults (Demirgüç-Kunt and Klapper, 2012, pp. 53-57). This, then, explains why McKinnon's conduit effect is dominant in the impact of financial systems on poverty reduction.

Many studies have attempted to assess the actual impact of financial development on poverty, but their findings vary. We have shown, on the basis of a panel of 67 developing countries over the period 1966-2000, that the poor benefit from the capacity of banks to perform transactions and to offer opportunities to invest savings through deposit accounts, but benefit little from bank lending, which tends to confirm McKinnon's conduit effect (Guillaumont Jeanneney and Kpodar, 2006a; 2006b; 2011). Two poverty indicators were used: average per-capita income in constant dollars of the poorest 20% of the

14 This is the main reason why, at the beginning of the 1970s, McKinnon recommended the idea of freeing the financial systems of developing countries from constraints that slowed down their development, such as control of interest rates, high reserve requirements, selective lending and other distortions due to government intervention.

population (Dollar and Kraay, 2002), and the proportion of the population earning less than $1 a day (measured at 1993 purchasing power parity; see Chen and Ravallion, 2001).[15] After controlling for per-capita income to isolate the effect of financial development stemming from economic growth, the ratio of liquid assets of the financial system to GDP (M3/GDP) has a positive effect on the income of the poor (or reduces headcount poverty). This effect is stronger where the density of banks is high and average per-capita income in the country is lower, which shows that the conduit effect may be particularly relevant in low-income developing countries. However, the ratio of private bank credit to GDP has no significant effect on the poverty level unless the geographical coverage of banks is extensive, and this impact is much smaller than that of the liquidity ratio.[16] This result is unsurprising given that in some countries, a high bank loan ratio may coincide with a low percentage of adults who receive bank loans or have accounts (Demirgüç-Kunt and Klapper, 2012, pp. 18-19).

However, this last result contrasts with those of Honohan (2004) and Beck *et al*. (2007). Although these authors do not test the effect of the liquidity ratio, they show that bank lending has a significant impact on the income of the poorest quintile of the population or the poverty headcount. Honohan only uses cross-sectional data without addressing the issue of causality, while Beck *et al.* use the same econometric method as in our 2006 and 2011 studies (panel and instrumentation by GMM system), with a slightly different sample covering 72 developed and developing countries over the period 1960-2006. The result found by Beck *et al.* (2007) might be driven by the heterogeneity of the sample, which covers developed countries as well as developing countries, including emerging ones whose financial systems have experienced very rapid growth; therefore this result probably does not have the general applicability that is ascribed to it.[17,18]

The analysis of Kiendrebeogo and Minea (2013) previous studies by not using indicators related to the amount of financial assets but, instead, those representing access to financial services: the percentage of the adult population having an

15 As well as the poverty headcount, we also use the poverty gap indicator, which considers how far away the income of the poor population is from the threshold of US$1.

16 It can therefore be estimated (with the usual precautions) that on average, an increase in M3/GDP of 10 percentage points (or half of its standard deviation) increases the income of the poorest 20% by around 2.6% where bank density is low (one bank branch per 10 km^2). This percentage increases to 3.5% where bank density is 10 branches per km^2 (the highest density in the sample). However, the same increase in the ratio of bank loans to the private sector does not increase the income of the poorest where bank density is low, though it could increase income by 3% where bank density is high.

17 If the same regressions are performed without Thailand and Indonesia, the significance of the coefficient of the lending-to-GDP ratio disappears, unlike that of M3/GDP (Guillaumont Jeanneney and Kpodar, 2011).

18 Akhter and Daly (2009) attempt to reconcile the previous studies with a double positive effect on poverty reduction of the liquidity ratio and the ratio of loans to the private sector. This result stems from the use of a different econometric method (that of fixed effects broken down into explainable and unexplainable components). However, this method only makes it possible to partially control for the risk of endogeneity of the variables.

account with a financial institution,[19] the number of bank loans per 1,000 people and the number of deposit accounts per 1,000 people (Demirgüç-Kunt *et al.*, 2007). The econometric analysis is carried out on cross-sectional data for 85 developing countries, with the indicators of access to financial services being instrumented by the legal rights of creditors (Djankov *et al.*, 2007). There is a significantly negative effect on the variation of the poverty headcount between 2005 and 2008 for the three indicators calculated for the year 2005. Since the number of deposit accounts per 1,000 people is on average six times higher than that of loans and since its coefficient is slightly higher, the effect on the reduction in the poverty headcount brought about by access to deposits is much greater than the effect of access to loans, which is consistent with McKinnon's conduit effect.[20]

2.2. How can the direct impact of finance on the poor be increased?

To identify how the financial system could reduce poverty more effectively, it is necessary to understand the obstacles that prevent the poorest from accessing banking services.

Obstacles preventing the poor from accessing finance

There is certainly a need to distinguish the factors that constrain the access to financial services from those that limit their usage for social, cultural or religious reasons, with the former being those that call for policy action (Beck *et al.*, 2009). Two methods are available to assess these factors. One is to use quantitative indicators that combine the number of users of accounts or bank loans with objective data, such as the number of bank branches per square kilometre or the number of documents required by banks and the cost of banking services. The second method involves surveying companies and households to find out their characteristics as well as the main obstacles that they feel prevent them from using banking services.

The positive relationship that the proportion of the population holding a bank account has with the number of bank branches per square kilometre and its negative relationship with the cost of opening an account (Beck *et al.*, 2008) show that two objective barriers exist. One is distance to a financial institution, and the other is the cost of opening an account in terms of the large number of documents required, the minimum deposit needed and the amount of the fees. The factors that slow down lending to the poorest as perceived by banks are the lack of guarantees (mortgages or securities), proof of employment or steady future income, on the one hand, and the proportionately high cost of granting small loans on the other hand.

By surveying households, our knowledge of barriers that impede access to financial institutions can be refined. The most recent and complete source is the

19 The indicator of the number of accounts may not capture well the number of individuals who hold at least one account as a single individual can hold several accounts. Also, in the database used the number of people holding at least one account is partly obtained by econometric extrapolation.

20 The poverty gap regressions give non-significant results except in the case of access to loans, but the coefficient is very low. This counterintuitive result is not explained.

Global Findex Database, which is made up of surveys carried out in 2011 by Gallup in 148 countries on 150,000 people under the aegis of the World Bank. These surveys, which are expected to be repeated every three years (Demirgüç-Kunt and Klapper, 2012),[21] reveal a wide disparity between individuals in terms of access to both deposits and bank loans according to gender (men are favoured over women), education level (the higher the level, the greater the access to banking services), age (the intermediate population is favoured over young people aged 15-24 and people aged over 65), and whether they live in towns or the countryside (urban dwellers are favoured).[22] The proportion of the population that is disadvantaged in terms of these criteria is particularly high among the poor population, which is made up of more women, more people with a low level of education, more rural dwellers and more young and old people due to emigration from the countryside to towns.

The responses regarding the main reasons why individuals do not have a bank account are enlightening. The top two reasons are financial in nature, the first being low income (which affects the poor in particular) and the second, which is often combined with the first, that accounts are very expensive and it is better to use the account of another member of the family. The other reasons, in decreasing order of importance, are distance to the bank, not having the necessary information, a lack of confidence, and religious reasons. The same question is not asked in relation to formal loans.

A lack of confidence in the banking system being one of the factors inhibiting the use of deposit accounts (13% of respondents) is due to recurring banking crises in developing countries, which cause banks to freeze deposits. As we have already noted, this hits the poor particularly hard as they are unable to diversify the composition of their financial assets as the more well-off sectors of the population can.

What can be done?

Priority should probably be given to access to deposit accounts more than loans due to a number of reasons. The obstacles to the development of accounts for the poor are probably easier to overcome than those relating to lending; access to modern payment methods and financial savings instruments should be universal, whereas not all individuals are eligible for bank loans. The subprime crisis in the US shows the dangers of lending amounts over and above the repayment capacity of low-income households. This priority is also justified by the efficacy

21 The data bank can be accessed on the website of the World Bank. Unfortunately, it does not allow the income level of individuals (including whether or not they belong to the poorest quintile of the population) to be combined with the characteristics of individuals or the importance of the reasons for not having a bank account. A detailed report on the findings of this database, with a particular focus on Africa and the Franc Zone, is provided by Guérineau and Jacolin (2014).

22 In developing countries, on average 46% of men had an account and 19% benefited from credit compared with 37% and 16% for women, respectively. Of people with at least a primary education, 35% had an account and 14% percent obtained credit, compared with 49% and 21%, respectively, for people with secondary education. Of the urban adult population, 50% had an account and 21% received a credit, while these figures are 38% and 16%, respectively, in rural areas (Demirgüc-Kunt and Klapper, 2012, pp. 53-54).

of the 'conduit effect' of bank deposits in reducing poverty. Furthermore, owning an account with a bank opens the door to bank loans through the relationship that it creates between the bank and its customer.

Two major types of action aimed either at the poor or at banks are possible. Educating and informing poor populations about the role of banks is essential and would justify a change in curricula and probably primary and even secondary and vocational teaching methods, in particular for women. As for banks, greater competition (for instance, through greater market openness to regional or foreign banks) could be more effective than interest rate control in lowering financial service costs. But the growth of the banking system must be accompanied by effective oversight to prevent bankruptcies from undermining the fragile confidence of poor populations in banks. The development of mobile banking, which is already well under way in Africa, is a vital means of overcoming the obstacle of distance and enabling people living in rural areas to access banking services. In terms of interest rates and the frequency of deposits and withdrawals, savings instruments should be tailored to the behaviour and limitations of poor populations.[23]

The reforms that are necessary to develop lending to small enterprises and poor households are more complex (Beck *et al.*, 2009). The most urgent is probably the creation of risk registries to enable small loans to be recorded easily and reliably, in order to reduce the cost of informing financial institutions about credit histories. Next is shoring up the property rights of poor populations, especially those of farmers over their land, by creating land registries. Finally, bank services should be expanded to include insurance against economic and idiosyncratic shocks (including health), because the main reason for formal or informal borrowing by the poorest quintile of the population in developing countries is emergencies (14% as compared with 8% for the wealthiest quintile according to the Global Findex Database).[24] These reforms are long term and structural in nature and leave the door open for microfinance (Armendáriz de Aghion and Morduch, 2006), which has developed rapidly because microfinance institutions (MFIs) go to the poor instead of waiting for the poor to come to them. The loan recovery rate is often remarkable thanks to the use of group loans and a gradual increase in the amount of loans. But MFIs struggle to cover their costs and to survive without subsidies from governments or international donors, and they are more active in the realm of consumer loans than investment loans. The reconciliation of banks and MFIs is a desirable course of action: banks can offer MFIs profitable investment opportunities for the deposits that they collect, and MFIs can offer banks their knowledge of poor populations.

23 See Chapter 10 in this book (by Bruno Cabrillac).
24 See Chapter 16 in this book (by Alain de Janvry and Elisabeth Sadoulet).

Conclusion

Financial development contributes to poverty reduction, not only through growth but also directly by encouraging access for the poor to the financial system. In addition, it is possible that the extension of financial services to new segments of the population and the concurrent reduction in poverty in turn affect economic growth favourably. At the end of this discussion, we believe that three main policy conclusions should be highlighted.

First, financial development generates growth that is more pro-poor when credit goes to those sectors or businesses whose expansion mostly benefits the poor. Government authorities and donors should put in place the necessary conditions and appropriate reforms to stimulate lending to neglected sectors (such as agriculture and SMEs). Second, the poor are hit hard by the financial instability that affects many developing countries on a recurring basis. The strengthening of banking oversight institutions and policies to safeguard macroeconomic stability are therefore justified. Third, while the development of lending to the poor is certainly desirable, given the difficulty of this task it is important to bear in mind the effectiveness in terms of reducing poverty of a policy improving access of the poor to an efficient payment system and to safe and profitable investments of their savings. This objective is easier to achieve swiftly than that of access for the poor to formal loans. In parallel with microfinance, access for the poor to bank loans could be gradually expanded by improving the geographical coverage of banks, reducing access costs (including through increased banking competition and the use of innovative solutions such as mobile finance), better definition of property rights and increased financial literacy.

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18

Aid for Trade as Finance for the Poor[1]

Jaime de Melo and Laurent Wagner

The Aid for Trade (AFT) initiative was announced at the 2005 Hong Kong WTO Ministerial Conference. Then, Doha round talks were stalled as developing countries were disenchanted with the world trading system they had signed up to a decade earlier under the Single Undertaking, whereby all members signed up to the same rules even though differential treatment for the Least Developed Countries (LDCs) provided some preferential market access to OECD markets and longer time periods to implement the obligations. So when AFT was started, market access to OECD countries had not improved because of dirty tariffication in agriculture, technical assistance funding to help implement the WTO agreements (customs valuation, sanitary and phytosanitary measures, trade-related aspects of intellectual property rights) was not forthcoming, and for the LDCs preferential access was dwindling as preferential agreements signed by developed countries were proliferating.

This chapter focuses on the channels through which AFT flows might help reduce poverty – the top priority under the MDGs (Goal 1A is 'Halve, between 1990 and 2015, the proportion of people living on less than $1.25 a day'). It does not deal with the voluminous literature covering the aid-growth nexus. At around US$30 billion a year, AFT constitutes about 30% of official development assistance (ODA) financial flows to developing countries (remittance flows are more than the combined ODA and FDI flows). So trying to isolate the effects of AFT from other financial flows is like looking for a needle in a haystack. Hence the focus is on the channels linking AFT to poverty reduction through trickle-down effects and a reduction in trade costs; as well as on multiple rather than single-country studies to emphasise generalisable results.[2]

Section 1 reviews briefly the history of the AFT initiative and the challenges it faces, while Section 2 discusses how the adding of objectives has complicated the evaluation of AFT. Section 3 contends that the evidence supports the view that trade is the engine of growth rather than the other way around, and Section 4 gives evidence of the trickle-down effects of growth. Section 5 reports the evidence on the obstacles to trade caused by poor infrastructure and on the links between AFT disbursements and reduced trade costs. Section 6 concludes

1 We thank Matthieu Boussichas, Olivier Cadot, Patrick Guillaumont, Mariana Vijil and Richard Newfarmer for comments on an earlier draft.

2 Cadot *et al.* (2014) and Cadot and de Melo (2014b,c,d) provide a critical survey of what we know (and don't know) about the efficacy of Aid for Trade with a greater focus on lessons from case studies.

that the recently signed Trade Facilitation Agreement provides the opportunity to direct resources towards countries with the highest trade costs and highest poverty rates.

1. Origins and challenges facing the Aid for Trade initiative

The AFT initiative was launched in 2006 as support to the MDGs (Goal 8: "Developing a global partnership for development") with, as targets, a rules-based, open, multilateral trading system and improved market-access including duty-free, quota-free market access for LDCs. It was designed to assist the WTO in addressing two clear challenges that were then plaguing the Doha negotiations by (i) providing assistance – financial and technical – to help developing countries, particularly LDCs, to build the needed supply-side capacity to 'implement and benefit from WTO agreements' they had signed up to; and (ii) raising and disbursing rapidly substantial funds needed to gain support for and breathe new life into the stalled Doha negotiations. Since the Doha talks remained stuck, the second challenge took precedence.

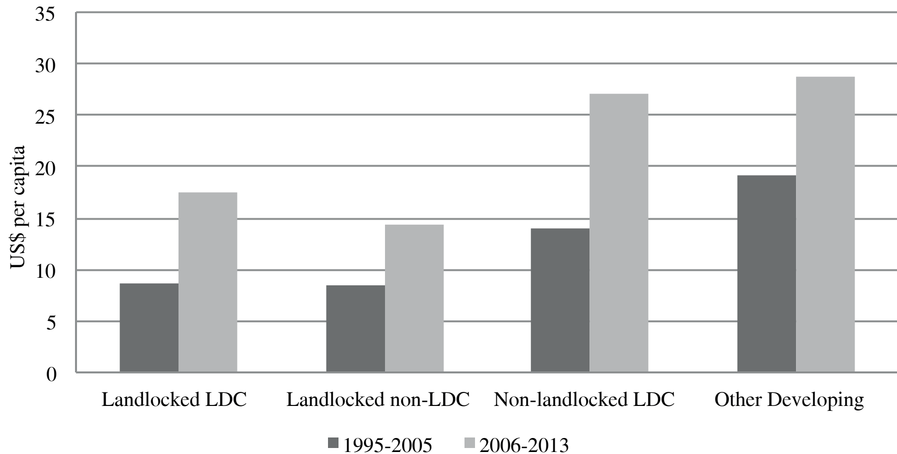
To ensure rapid disbursement, it was decided that AFT would take place through existing channels rather than through the creation of a new dedicated fund for delivery.[3] This led to confusion in classification: an existing infrastructure project could now be branded as AFT by donors, while recipients reported that they did not receive any AFT. By the time the decisions about the reporting of AFT flows in the OECD's Creditor Reporting System (CRS) were finalised, 30% of all sector-allocable official development assistance was potentially attributable to AFT.[4]

In spite of these shortcomings in defining AFT, the trends in Figure 18.1 show that a donor effort is visible in the increase in the average per capita disbursement over the AFT initiative period. And by other measures, such as word counts of trade-related key words in national budget speeches, trade became more important in national economic objectives, leading some observers to conclude that the objective of mainstreaming trade in national development strategies was occurring in plans, if not in practice (Newfarmer, 2014).

3 Among other qualification requirements, AFT as part of ODA concessional flows excludes IBRD, IFC and IDB lending and investments for trade. It also excludes non-DAC countries, notably the BRICS, and especially China's presence in Africa.

4 Measurement issues plague the CRS, making it difficult to know what really qualifies as AFT. For example, the CRS does not provide information about trade-related technical assistance and trade development, which was previously collected under the joint OECD-WTO Trade Capacity Building Database. Disbursements for multilaterals are also badly tracked.

Figure 18.1. *AFT disbursements per capita from 1995 to 2013*



Notes: LL-LDC (16): Afghanistan, Bhutan, Burkina Faso, Burundi, Central African Republic, Chad, Ethiopia, Lao People's Democratic, Lesotho, Malawi, Mali, Nepal, Niger, Rwanda, Uganda, Zambia. Non-LL LDC (33): Angola, Bangladesh, Benin, Cambodia, Cape Verde, Comoros, Congo, Dem. Rep., Djibouti, Equatorial Guinea, Eritrea, Gambia, Guinea, Guinea-Bissau, Haiti, Kiribati, Liberia, Madagascar, Mauritania, Mozambique, Myanmar, Sao Tome and Principe, Senegal, Sierra Leone, Solomon Islands, Somalia, Sudan, Tanzania, Timor-Leste, Togo, Tuvalu, Tanzania, Vanuatu, Yemen. LL Non-LDC (14): Armenia, Azerbaijan, Bolivia, Botswana, Kazakhstan, Kyrgyz Republic, Moldova, Mongolia, Paraguay, Swaziland, Tajikistan, Turkmenistan, Uzbekistan, Zimbabwe.
Other developing (87): Albania, Algeria, Antigua and Barbuda, Argentina, Barbados, Belarus, Belize, Bosnia and Herzegovina, Brazil, Bulgaria, Cameroon, Chile, China, Colombia, Congo, Dem. Rep., Costa Rica, Cote d'Ivoire, Croatia, Cuba, Dominica, Dominican Republic, Ecuador, Egypt, Arab Rep., El Salvador, Estonia, Fiji, Gabon, Georgia, Ghana, Grenada, Guatemala, Guyana, Honduras, Hungary, India, Indonesia, Iran, Islamic Rep., Iraq, Jamaica, Jordan, Kenya, Korea, Dem. Rep., Latvia, Lebanon, Libya, Lithuania, Malaysia, Maldives, Marshall Islands, Mauritius, Mexico, Micronesia, Fed. States., Montenegro, Morocco, Namibia, Nicaragua, Nigeria, Oman, Pakistan, Palau, Panama, Papua New Guinea, Peru, Philippines, Poland, Romania, Russian Federation, Samoa, Serbia, Seychelles, South Africa, Sri Lanka, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadine, Suriname, Syrian Arab Republic, Thailand, Tonga, Trinidad and Tobago, Tunisia, Turkey, Ukraine, Uruguay, Venezuela, RB, Vietnam, West Bank and Gaza.

Source: Authors' calculations based on OECD-CRS data.

As to the first challenge – to help build the supply-side capacity needed to 'implement and benefit from WTO agreements' – after four biennial reviews of the OECD-WTO task force (a fifth one is due in June 2015), showing that AFT flows have helped countries build their supply-side capacities has proved elusive. Evaluations have faced an inescapable tradeoff between 'internal validity' (the ability to distinguish impact effects from confounding factors), which improves as one goes from aggregate level cross-country studies to impact evaluations, and 'external validity' (the ability to draw general policy propositions from evaluation results), which may well worsen as case studies and most randomised control trials do not generalise easily to other environments. Furthermore, many trade policy reforms, such as tariff and non-tariff barrier reductions, are not suitable for impact evaluation methods.

2. Expanding the scope has muddled AFT evaluation

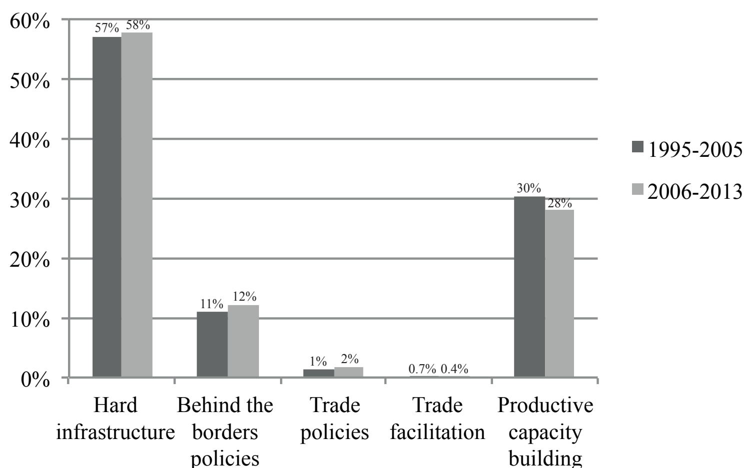
Under the haste to raise funds to support the Doha negotiations, little effort was spent on coordination and on how to conduct evaluations. With funding becoming scarce as the financial crisis unravelled, showing results became more important. The focus of evaluation shifted from accountability to outcomes, but progress was slowed by donors using different yardsticks in their monitoring, all based on self-reporting and self-assessment of case stories. As these case stories were voluntarily supplied, observers commented that evaluation had turned into a 'beauty contest' (Hallaert, 2013). In effect, beyond winning the argument on mainstreaming trade in national development strategies, the AFT reviews turned out to be more about expanding the agenda than about conducting an evaluation of the effectiveness of AFT. Thus the WTO AFT work programme for 2012-2013 covered new issues ('gender empowerment', 'green growth', 'climate change', 'global value chains') to keep up the momentum in mobilising funds and to maintain the interest of bilateral donors and development agencies in the Doha negotiations.[5]

The difficulties in evaluating AFT effectiveness are apparent in Figure 18.2, which shows AFT disbursements from the CRS database classified according to the broad categories of AFT: (i) technical assistance for trade policy and regulations; (ii) trade-related infrastructure; (iii) productive capacity building (supporting the private sector to develop its comparative advantages and diversify its exports); (iv) trade-related adjustment; and (v) other trade-related needs that are not covered under CRS data. Under this classification, one third of disbursements go to productive capacity building activities whose contribution to increased trade or to greater trade diversification is hard to capture and hard to distinguish from confounding factors.[6] For example, Hallaert (2013) notes an urban transportation project for Istanbul that made Turkey the third largest recipient of AFT in 2008. In any case, Figure 18.2 shows no change in AFT disbursement patterns either towards 'hard' (e.g. roads and bridges) or 'soft' (e.g. trade policies and trade facilitation measures) infrastructure activities, both of which have been found to be positively associated with increased trade. A narrower definition of AFT – taking out the productive capacity building category and perhaps collapsing AFT into two categories, 'hard' and 'soft' – would help us see more clearly any change in trends in 'essential' AFT flows.

5 In one of its summaries, the WTO concluded that, '[e]conomic growth, poverty reduction and regional integration remain the main focus of policy, but other priorities from the broader coherence agenda are increasing in importance in donor strategies' (WTO, 2011).

6 Acknowledging this issue, since 2008 the OECD has included a 'trade development marker' in the CRS database to help in disentangling the capacity-building categories of aid flows directly aimed at enhancing trade.

Figure 18.2. *AFT disbursements by category*



Notes : 'Hard infrastructure' includes transport- and energy-related infrastructures. 'Behind the borders policy' includes a range of interventions related to communications, business and banking. 'Trade policy' focuses directly on trade policy design and implementation. 'Trade facilitation' concerns the simplification and harmonisation of international import and export procedures. Finally, 'productive capacity building' includes aid to agriculture, industry and mining. See the annex in Cadot and Melo (2014e) for the necessary adjustment to the CRS database to include trade-related technical assistance and trade development activities.

Source: Authors' calculations based on OECD-CRS data.

3. Trade as an engine of growth

The fact that no country has succeeded in the long run by closing itself to trade is accepted. Exports are part of GDP, so it is tautological to say that GDP growth is correlated with export growth. But stating that export growth causes GDP growth has continued to be controversial, at least until recently. Relying on panel techniques that control better for country specificities, Wacziarg and Welch (2008) upheld a widely cited study by Sachs and Warner (1995): countries liberalising trade experienced growth accelerations of the order of 2% per year. These results were still subject to confounding influences, as trade liberalisation was usually part of broader reform packages and subject to reverse causality.[7] However, this criticism has been largely addressed by Feyrer (2009) with a time-varying instrument. He estimates that trade growth explains approximately 17%

7 Frankel and Romer (1999) showed that after controlling for geographical characteristics (the only exogenous factor in the trade-growth nexus), trade correlated positively with accumulated growth (i.e. income). However, Rodrik *et al.* (2004) showed that the results were not robust to the inclusion of latitude and institutional quality variables, leaving open the critique that instruments given by geography were static and therefore confoundable with many other country characteristics. Using time-varying instruments (rainfall and OECD growth) in a panel, Brückner and Lederman (2012) estimate that a one percentage point increase in the trade-to-GDP ratio causes a 0.5 percentage point increase in GDP.

of the variation in cross-country income growth between 1960 and 1995.[8] In sum, the accumulating evidence strongly suggests that these confounding factors are being more convincingly controlled so that, in the end, trade does cause growth.

Showing that AFT flows lead to an increase in exports is more difficult and so far direct evidence is still limited, although in Section 5 we report evidence that AFT notably increases exports through improvements in infrastructure. Start with simple correlations between past per-capita AFT and subsequent export growth. Cadot *et al.* (2014e) rank AFT recipients by average per-capita AFT received during 2000-2005, then for each quintile, they split countries into two cohorts: 'low recipients' and 'high recipients'. They fail to detect higher per-capita export growth in the high recipient group over the next five-year window (2005-2010). However, controlling for confounding macroeconomic factors and endogeneity, Cali and Te Velde (2011) and Vijil and Wagner (2012) show that, on average, AFT disbursements influence trade performance positively. Based on this evidence, in Section 5 we report that AFT notably increases exports through improvements in infrastructure.

Using project-level data, Brenton and Von Uexkull (2009) show that product-specific technical assistance projects coincided with increased exports of supported product lines, but they note that the projects might have been selected in the first place because they were growing fast. On a more positive note, on the other hand, fears that aid is tied to donor exports resulting only in gains to donors are not vindicated in recent data covering the period 1990-2010. Furthermore, taking AFT from all donors (rather than dyadic relations), Helbe *et al.* (2012) find that AFT increases exports of recipient countries to donors, as well as imports of recipients from donors. These results were corroborated later by Vijil (2014) for partners in a free trade agreement and Hühne *et al.* (2014), who also show that the first effect systematically dominates the second, allaying fears that donors grant AFT primarily to promote their own export interests.

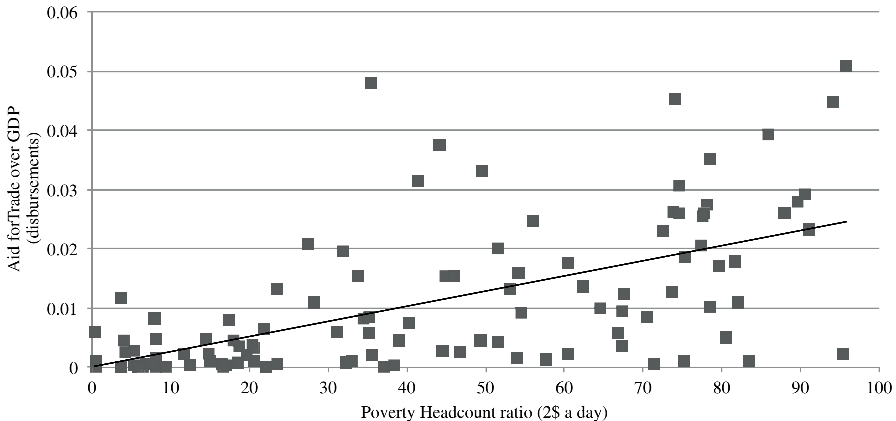
4. Does AFT contribute to reducing poverty?

So accepting that AFT improves trade performance and that trade causes growth, does growth then trickle down to the poor? Multiple within-country household surveys show that, on average, growth is 'good for the poor' in the sense that income (or consumption) growth of the lowest deciles matches growth of the higher deciles in the distribution (Dollar and Kraay, 2002; Dollar *et al.*, 2013). Dollar *et al.* (2013) estimate that 62% (77%) of cross-country variation in the growth of incomes of the poorest 20% (40%) of the population is due to growth in average incomes, and that any of the included proxies for policies and institutions are significantly correlated with growth in incomes of the poor,

8 Exploiting the observation that a technological change (the lowering of air freight costs relative to maritime costs) has benefitted country pairs with relatively short air routes compared to sea routes gives a measure of distance that changes over time, thereby allowing for the inclusion of country fixed effects eliminating the bias from omitting time-invariant variables (e.g. institutions or distance from the equator).

beyond any direct effect of these variables on growth itself. In sum, on average, there is growth 'trickle-down' and trade indirectly contributes to raising the income of the poorer households. Winters and Martuscelli (2014) also conclude that trade liberalisation generally raises average incomes by boosting growth temporarily. So, insofar as AFT reduces trade costs and/or encourages exports – either through at-the-border or behind-the-border measures – it should on average contribute to reducing poverty, as improved trade performance raises income.

Figure 18.3. *AFT disbursements and poverty*



Notes: LLDCs: landlocked developing countries. The poverty headcount ratio is based on a mixture of consumption and income micro studies depending on the best available data.

Source: Author's calculations from CRS, WBI and Povcal.net data.

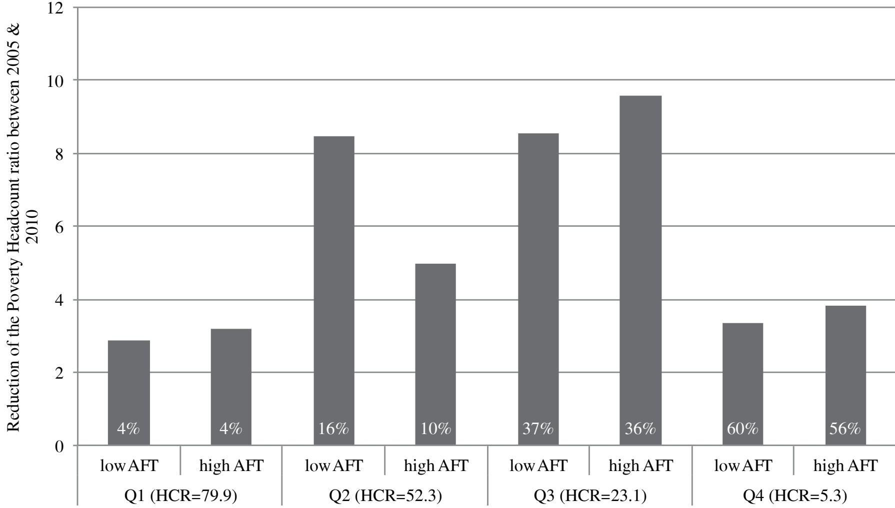
There is sketchy evidence that aid reduces poverty and that trade liberalisation has ambiguous effects on income inequality, but the established links between openness, poverty and the distribution of income are tenuous.[9] The next two figures aim at providing some crude illustrations of the link between AFT and poverty reduction. First, for AFT to reduce poverty, it's disbursement should prioritise countries with the highest poverty rates. Figure 18.3 plots average per capita AFT disbursements since the start of the AFT initiative period against initial poverty rates around 2005 (the US$2 per day cut-off is to ease readability).[10] The scatter plot shows that per-capita disbursements went mostly towards countries with high beginning-of-period head count ratios, a not surprising pattern since

9 Using dynamic panel techniques, Alvi and Senbeta (2011) find that aid reduces poverty. Even though fixed effects are included, these results are prone to biases raised in the openness-growth literature discussed above.

10 In 2010, around 2.4 billion people live under US$2 a day, with an average yearly reduction of the headcount of 0.4% (1.0%) excluding (including) China (Ravallion, 2015) over the period 1990-2010. For reasons relating to the growing tensions in donor countries in the post-cold-war period, Pritchett (2015) points out that the 'dollar a day' standard of extreme poverty actually attempts to 'define development down' and that a much higher cut-off figure would be needed to reflect the development objectives of aid recipients.

AFT is concessional and, as such, is mostly directed to LICs. This is not to say that AFT is directly targeted to the poor, but rather that, on average, the poorest countries tend to also face the highest trade costs, a point made by the results in Gamberoni and Newfarmer (2014).

Figure 18.4. *AFT disbursements and poverty profiles*



Notes: Sample of 109 developing countries. HCR = headcount ratio. The figures in the bins represent the percentage reductions in HCR between 2005 and 2010.

Source: Author's calculations from CRS, WBI and Povcal.net data.

Figure 18.4 presents rough evidence that the amounts of AFT disbursed in developing countries tend to be positively correlated with poverty reduction. To control for economic size, Figure 18.4 uses per-capita disbursements rather than disbursements over GDP as in Figure 18.3. Countries are classified by quartiles from highest to lowest initial (around 2005) headcount ratios (HCR), with countries split into 'low recipient' and 'high recipient' bins within each quartile. If countries within each quartile faced 'similar' conditions, and if AFT had a sizeable impact on poverty, then within each quartile, the highest recipients of AFT funds would show the greatest reductions in poverty as measured by the absolute percentage point reduction in the HCR. From the sample of 109 countries used in Figure 18.4, this is roughly the case. Only in the second quartile are the countries with the larger poverty reduction between 2005 and 2010 those that received less AFT on average. However, when looking at the percentage reduction in poverty (i.e. the percentage reduction figures in the bins), the association of reduction in poverty with AFT disbursements across quartiles is weak. Initial levels of inequality could contribute to this pattern, as the poverty impact of a given rate of growth would be less if initial inequality were higher (Ravallion, 2015, Chapter 10). Alternatively, aggregate-level evidence drawing on summary measures of poverty and inequality are subject to the influence

of confounding factors, explaining also the mixed results from Figure 18.4. It also explains why there is so little aggregate evidence that AFT reduces poverty directly or that it has a noticeable impact on the distribution of income.

Indeed, AFT can potentially influence poverty directly or indirectly through many channels, and those impacts are difficult to capture at the macroeconomic level because of confounding factors. The list of potential channels is long, related to very diverse economic mechanisms and their detailed exploration well beyond the scope of this chapter. We mention two examples here: improvements in infrastructure and improvements in productive capacity. Casaburi *et al.* (2013) evaluate the effects of an EU feeder road rehabilitation programme in Sierra Leone. They find that the market power of a few intermediaries is strongly reduced as the price of cassava is increased by 18% along rehabilitated roads and the costs of goods sold in rural areas is reduced. Both effects should be pro-poor.

Alternatively, aid to productive capacities, as part of AFT, can indirectly influence poverty through targeted investments, notably in agricultural production. By financing training in agriculture, irrigation projects, the supply of fertilizer and so on, AFT should contribute to raising the productivity of poor unskilled farmers who are close to, or below, the poverty line. For example, Dillon (2011) evaluates irrigation investments in northern Mali. He finds significant positive increases in total household consumption, agricultural production, informal food sharing and livestock holdings for households who have access to irrigation. These results suggest that pro-poor welfare gains can be realised with targeted investments in an area with low agricultural potential and high vulnerability to climatic shocks. Furthermore, Dercon and Christiaensen (2011) investigate the impact of the risk of poor consumption outcomes on the adoption and use of fertilizer in Ethiopia. They show that the use of fertilizer results in higher yields and substantial returns on average. They also show that the use of fertilizer is a high-risk, moderate-reward activity, as returns tend to be lower than without fertilizer given the sunk cost of the input. They conclude that measures that remove the risks linked to bad weather conditions – such as insurance schemes or drought-resistant varieties – can increase yield, helping overcome risk-induced poverty traps.

Learning more about how AFT might reduce poverty also requires household data, which can be used to trace the channels through which reduction in trade costs affect poverty. Improved access to infrastructure and changes in at-the-border and behind-the-border policy measures will affect households through three main channels: changes in labour income via changes in wages; changes in revenue through changes in production induced by changes in prices or access to infrastructure; and changes in consumption patterns through changes in prices of goods consumed by households. Micro studies can help to highlight the dynamic between trade performance and poverty in specific contexts and how AFT can strengthen or dampen this relationship. For example, Nicita *et al.* (2014) use household surveys for six SSA countries (Burkina Faso, Cameroon, Côte d'Ivoire, Ethiopia, Gambia, and Madagascar) to trace the effects of an elimination of protection (tariffs and non-tariff barriers) on the entire distribution

of income. They find that in five of the six countries, the current protection structure has a pro-poor bias because of the dominating effect of the favourable effect of high protection of agricultural goods that are sold by the poorest households (an elimination of protection would reduce the skilled-unskilled wage gap, but the effect would be dominated by the loss of income due to the lower prices of goods sold by the poorest households). Other studies surveyed by Winters and Martuscelli (2014) reach the similar conclusion that, at least in the short to medium term, the consumption effect dominates so that a reduction of protection is likely to be anti-poor if agricultural productivities are relatively more protected.

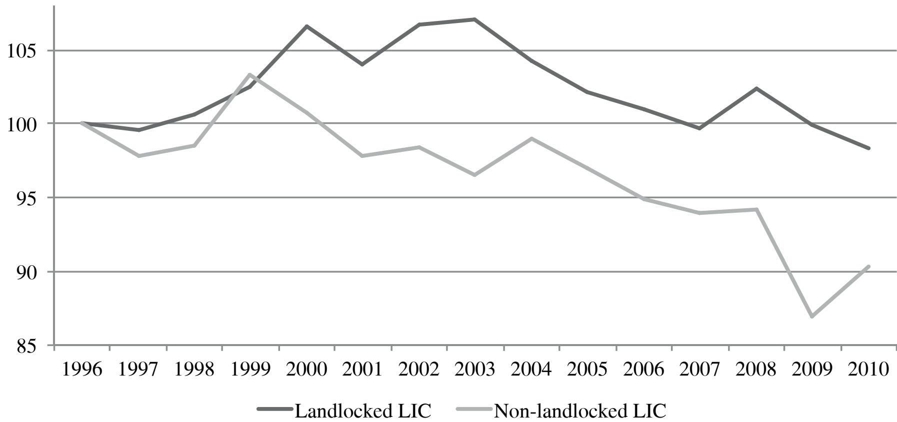
5. Reducing trade costs should remain the key objective for AFT

It is widely accepted that trade costs are the major determinant of trade performance and there is evidence that AFT flows have contributed to increasing trade flows through 'soft' and 'hard' infrastructure channels. According to the ubiquitous gravity model of trade, reductions in trade costs account for about one third of the increase in the volume of trade.[11] Take as an example the Istanbul Program of Action, which calls for a doubling of the global share of LDC exports by 2020. Then, at equal income growth rates, LDCs would have to reduce their trade costs twice as fast as those of their competitors in world markets.

Figure 18.5 gives a breakdown of the evolution of normalised average trade costs for landlocked low-income countries (LL-LICs) relative to non-LL-LICs. The figure shows that LL-LICs have been losing ground over the past 15 years. Because LL-LICs trade mostly low-value products transported by sea, they did not benefit from the dramatic fall in air transport costs. Less improvement in logistics performance must have been another important factor in the relative performance across country categories. In any case, controlling for income growth, it is relative performance in trade costs that will determine the evolution of a country's share in world trade.

11 If one accepts that structural gravity holds on the data (and that income and trade are jointly determined), the inverted gravity approach provides an estimate (rather, a calibration) of aggregate trade costs directly obtained from observable data. This gives the yearly ad-valorem estimates of total bilateral trade costs (including the effects of tariffs, language barriers, currency barriers, the equivalent of NTMs, etc.) shown in Figure 18.5. Besides being compatible with a large family of micro-based trade theories, these gravity-based calibrations have two advantages over common proxies of trade costs. First, they do not rely on a functional form for trade costs; second, they vary over time while typical proxies in the standard gravity approach (e.g. distance) do not vary over time. At the same time, the notion of trade costs captured in the gravity model subsumes all trade costs including new capacity, worker training, and so on.

Figure 18.5. *Calibrated trade costs (group averages), 1996-2009*



Notes: The figure shows average trade costs for goods with respect to the ten largest importing countries, by World Bank income groups, 1996-2009 (1996=100).
Landlocked low-income countries (17): Afghanistan, Malawi, Ethiopia, Lao PDR, Burundi, Burkina Faso, Tajikistan, Zimbabwe, Central African Republic, Chad, Uganda, Nepal, Niger, Kyrgyz Republic, Rwanda, Mali, Zambia.
Non-landlocked low-income countries (17): Bangladesh, Togo, Guinea, Sierra Leone, Madagascar, Congo, Dem. Rep., Mauritania, Eritrea, Ghana, the Gambia, Cambodia, Liberia, Benin, Tanzania, Mozambique, Kenya, Comoros.

Source: Authors construction based on Arvis *et al.* (2013).

Three components of trade costs have been scrutinised in gravity models of bilateral trade: (i) geography (i.e. size, terrain natural infrastructure such as water ways, country size, landlocked status, etc.); (ii) 'hard' infrastructure (roads, rail, ports, airports); and (iii) 'soft' infrastructure (border-related costs like customs administration and document preparation, border-related policies like tariffs and non-tariff measures (NTMs) in both domestic and destination markets, and behind-the-border policies like communications and regulatory policies). Of these, (ii) and (iii) are up for improvement by directed AFT. In most studies on the volume of bilateral trade, indicators of geography and hard infrastructure capture a larger portion of the variance in trade costs than indicators of behind-the-border policies. Several studies also find that differences in the values of proxy indicators for the quality of hard infrastructure contribute more towards accounting for differences in trade costs than differences in geography.

While proxies for both components of trade costs are found to have an impact on the volume of trade, there is controversy over their relative importance and over the distribution of AFT between 'hard' and 'soft' infrastructure (about 10% of AFT disbursements go to soft infrastructure). Limão and Venables (2000) estimated that hard infrastructure accounted for nearly half of the transport cost penalty borne by intra-African trade. Other evidence points towards the logistics market as the main driver of differences in trade costs across countries. Market power in maritime transport from 'shipping conferences' raises freight rates substantially. For road transport, Teravaninthorn and Raballand (2008) estimate

that widespread bilateral trade agreements and cartels throughout West Africa result in freight rates per ton being 80% higher and truck utilisation rates being 40% lower than in East Africa. Djankov *et al.* (2010) estimate that that 75% of time delays are attributable to weak institutional features, and 25% to poor physical infrastructure.

The implication of this work is that rather than just blindly following a ‘big push’ approach and building roads and bridges, donors should also pursue a policy dialogue hand-in-hand with recipient governments to improve regulatory frameworks and ensure competition in the provision of services. Improving the soft institutional and regulatory infrastructure will require less funding, but it is an integral part of trade costs. In conclusion, all quantitative evidence confirms the importance of trade costs without any component emerging as consistently more important.

A few studies have explored the channels through which AFT flows reduce trade costs and hence contribute to expanded trade. For example, Vijil and Wagner (2012) find that when all controls are included, the quality of hard infrastructure proxied by a composite index of roads and telecom densities is significantly positively correlated with aid to infrastructure. Ferro *et al.* (2014) find that aid to banking services and energy has significant effects on the performance of downstream manufacturing sectors.

6. Conclusions

The evidence reviewed here supports three broad conclusions. First, the accumulated evidence across countries supports the view that trade is an engine of growth rather than the other way around, and that growth trickles down. On average, growth is good for the poor and the incomes of the bottom 20% of the distribution rise in proportion to average incomes. Trade liberalisation also raises average incomes (i.e. boosts economic growth temporarily) but the effects on inequality and poverty are context-specific, depending both on the consumption pattern of the poor relative to the rich and on other complementary conditions.

Second, detecting direct effects of the AFT initiative at the macro level has proved to be difficult. This should not be surprising since aid flows characterised as AFT are dwarfed by other sources of capital flows and the categorisation of AFT is not conducive to analysing its effects on economic performance. However, several studies over longer periods of time, starting in the 1990s, have shown that AFT flows from all donors influence trade performance positively and that proxies for the quality of infrastructure are positively correlated with aid flows to infrastructure. Various indicators of hard and soft infrastructure have also repeatedly been found to be positively correlated with trade volumes, justifying the view that AFT disbursements should focus on measures that will reduce these trade costs.

Third, case studies, of which only a few have been mentioned here, have shown that AFT has helped reduce poverty through other channels. For example, aid targeted at productive capacity in agriculture and insurance schemes to remove risks can raise the productivity of households close to the poverty line. Road

rehabilitation can also reduce the monopsonistic power of traders in remote areas, thereby raising the incomes of the poor selling agricultural products. More lessons from case studies are summarised in the papers cited in the references.

In conclusion, as argued in our companion paper (de Melo and Wagner, 2015), the signing of the Trade Facilitation Agreement (TFA) in December 2013, which calls for specific measures to reduce trade costs caused by poorly functioning customs, has been fortuitous for AFT. While not all AFT funding would go towards implementing the TFA, this focus would have a double benefit: mobilising support and answering the call for managing for development results (MfDR), which cuts across the pillars of the Paris declaration.12 The aid community should therefore welcome the decision to focus the WTO's fifth Global Review of AFT, to be held in June 2015, on the theme of "Reducing Trade Costs for Inclusive, Sustainable Growth". Furthermore, by focusing AFT resources on LDCs, especially LLDCs, AFT would target funds towards countries with the highest trade costs and the highest poverty rates.

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12 Since 2012, the World Bank has had a third lending instrument called Program for Results, the first to directly link disbursements to results. Up to 5% of World Bank lending can go through this instrument, which is still in its early stages but has apparently met with success; see Gelb and Hashmi (2014).

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19

Pooling Risk, Pooling Hope: Towards a Global Compact for Sustainable Health Financing

Michel Sidibé

'The notion of human rights builds on our shared humanity. These rights are not derived from the citizenship of any country, or the membership of any nation, but are presumed to be claims or entitlements of every human being.'
Amartya Sen

1. Introduction: A universal right to and responsibility for global health

Our world is simultaneously shrinking and growing more complex. In today's interdependent and multipolar world, global health reflects vast asymmetries in interests. It also exposes large inequalities between countries in the distribution of health risks and the resources to address them.

Such power asymmetries are resulting in increasingly supranational determinants of health. The marketing strategies of global food and beverage companies directly impact the health of billions of people around the world, while climate change threatens to exacerbate food and water insecurity and extreme climatic events. HIV and other diseases continue to spread with the increasingly heavy flow of people across borders.

Progress towards the Millennium Development Goals (MDGs) conceals another aspect of our globalising world: growing health inequity within countries. Health among the most impoverished and disadvantaged ethnic and social groups is astonishingly poor. And even in the world's wealthiest countries, access to health services and the ability to make healthy choices is greatly limited for the poorest quintile.

These are challenges that can never be solved by one country alone, no matter how wealthy. Addressing and financing solutions to the non-communicable disease (NCD) epidemic and other transnational threats to health, in addition to the unfinished MDGs, demands an overhaul of our biomedical, donor-recipient, state-centric global health paradigm. The current institutional and financial structures cannot match the needs of an increasingly ambitious global health agenda. Furthermore, the global health system is not equipped to effectively address future threats – in terms of global governance, financing capacity,

service delivery systems, research and development (R&D) and community mobilisation.

With growing connectivity, emerging poles of power, the expanding role of non-state actors in global governance and intensifying global crises, global health financing is in dire need of a revolution. Forging the post-2015 development agenda – the successor framework to the MDGs – provides an opportunity to stage such a revolution.

As we examine the weaknesses of the current financing paradigm and weigh options for the future, several questions arise. How can the future of global health financing best seize the opportunities of our globalising world, while incentivising action on the global political determinants of poverty and health inequities? What do we hope to achieve with our investments? Are we investing enough and in the right things? Who should pay what, and who should receive what? Are governments accountable to their people, or to their donors? Lastly, who is being left behind, and why?

We need a collective shift in consciousness to harness the promise of globalisation and innovation for the fairer distribution of resources, health and opportunity. The primary responsibility for ensuring the *provision* of health care services will continue to rest with sovereign states. Yet the international community and global citizens must unite in a compact of global solidarity to ensure the *financing* of a minimum level of health care and to address the common determinants of ill-health across borders and populations. Global solidarity for health is not just about confronting the determinants and diseases that cross between countries; it is about recognising the inherent right to health of all people, no matter where they come from or who they are. This right must be central as the global financing debate turns to International Public Finance for Sustainable Development (IPF4SD).

Our world is marked not only by deep inequities, but also by an emerging appreciation of our shared identity and interdependence. Global solidarity can become the unifying force to redress health disparities and vulnerabilities and assure the realisation of the global citizen's right to and responsibility for health.

This chapter explores the evolving and broadening scope of global health as the international community debates the post-2015 development agenda. It reviews the transformation of global health financing over the last quarter of a century, and explores weaknesses that the current financing paradigm has yet to overcome. The Chapter argues for a global compact for health as a key mechanism of IPF4SD. Such a compact would be financed in part by a Global Health Equity Fund and driven by a movement of global citizens, to guide sustainable health-promoting action among governments, civil society and the private sector.

2. Enduring challenges, emerging threats: The evolving and broadening global health portfolio

Health is foundational. A prosperous society rests on healthy people, families and communities. While poor health and inequality are foremost a question of moral and political choice, such conditions come at great economic and social cost. Every year approximately 44 million households, or more than 150 million people, throughout the world face catastrophic health expenditures, while more than 100 million people are pushed into poverty by the need to pay for services (Marmot, 2014).

Conversely, the economic benefits of healthy populations are increasingly clear: the Lancet Commission on Investing in Health concluded that additional life-years due to health improvements were responsible for a remarkable 24% of the income growth in low- and middle-income countries (LMICs) from 2000 to 2011.[1] Investing in health and eradicating health inequity must therefore be a core element of ending poverty in the post-2015 era.

As both Marmot and Piketty point out, inequality and vulnerability are the result of political choices (Marmot, 2014; Piketty, 2014). Although some may argue that delivering basic health services and creating an enabling and health-promoting environment for all is costly, allowing the current level of health inequality to persist will be even more crippling.

The MDGs upheld the centrality of health to development, with three of the eight goals dedicated to health: maternal health (MDG 4); infant and child health (MDG 5); and HIV, tuberculosis and other infectious diseases (MDG 6). Remarkable improvements have been made in pursuit of these goals:

- Between 1990 and 2003, globally, the maternal mortality ratio dropped from 380 to 210 deaths per 100,000 live births.
- The likelihood of a child dying before the age of five has been nearly halved over the last two decades.
- Nearly 13 million people living with HIV today are on life-saving medication, and AIDS-related deaths are down 35% from their peak in 2005 (UNAIDS, 2014).
- Between 2000 and 2012, an estimated 3.3 million deaths from malaria were averted. Efforts to fight tuberculosis have saved an estimated 22 million lives worldwide since 1995.

Despite progress, it is certain that many countries will not meet the health-related MDG targets and much remains to be done beyond 2015. This is particularly so in the poorest countries, across sub-Saharan Africa and South Asia, and in countries affected by conflict.

Simultaneously, while the global health architecture and funding has predominantly focused on infectious diseases and conditions of poverty, NCDs have become the leading causes of death and disability worldwide. The misconception that NCDs – principally cardiovascular diseases, cancers, chronic

1 See the Lancet Commission on Investing in Health report (Jamison *et al.*, 2013).

respiratory diseases and diabetes – are an affliction of the affluent is increasingly outdated: 80% of all NCD-related deaths occur in LMICs. The burden of these diseases is rising fastest in low-income countries and poor communities where they impose massive, avoidable costs in economic, social and human terms (WHO, 2011).

The rapid explosion of chronic progressive diseases demonstrates how quickly the global health landscape can change. These illnesses also expose the complex interlinkages of public health with political, economic, social and cultural determinants of health, including the impact of big industry. Increased consumption of 'Big Food' products – sugar-sweetened beverages and processed foods enriched in salt, sugar, and fat – is closely correlated with rising levels of child and adult obesity, diabetes and other cardiovascular diseases (Basu *et al.*, 2012). Highly processed food, alcohol and tobacco consumption are on the rise across LMICs, in part due to the mass marketing campaigns and foreign direct investments of multinational companies in these countries.

As *The Lancet*-University of Oslo Commission on Global Governance for Health (2014) has emphasised, such transnational activities and political interactions involving actors with divergent interests and degrees of power are increasingly driving health inequity. These 'political determinants of health' arise in fields as diverse as trade, financial regulation, environment, intellectual property and human rights – all outside the spectrum of the health services sector.

To account for this expanding agenda, Frenk *et al.* (2014) have called for a reconceptualisation of global health. Rather than 'foreign health', our collective concern must be that of the health of the global population. This must be understood not as a manifestation of dependence but rather as the product of health interdependence, a phenomenon that has arisen in parallel with economic and geopolitical interdependence.

The debate on the post-2015 development agenda reflects the unprecedented complexity of global health. The Report of the Open Working Group on Sustainable Development Goals (OWG, 2014a) proposes targets reflecting this expanding health portfolio and is marked by a very high level of ambition. Success will demand radical changes in the way we do business, including improvements in cost-effectiveness – namely by targeting common, structural determinants of health. It will also require a significant increase in, and greater reliability and expanded scope of, global health financing.

3. From centralisation to complexity: A brief history of global health financing

'Golden era of global health' brings transformation

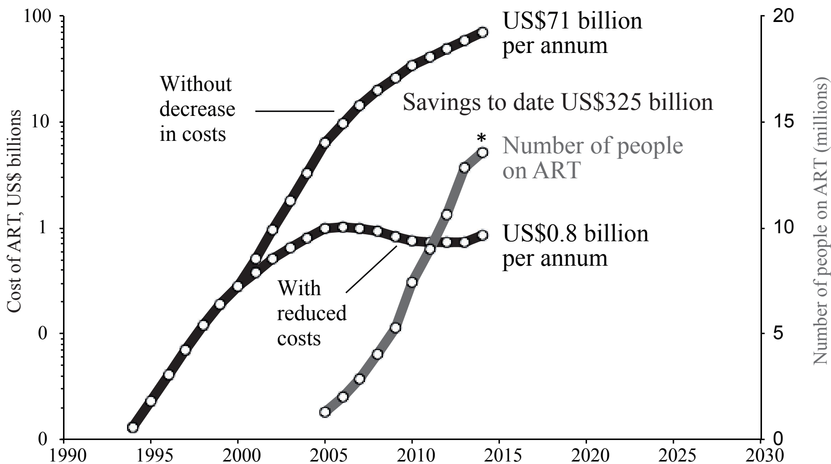
The global health architecture has undergone a significant transformation in recent decades. Twenty-five years ago, the World Health Organization (WHO) dominated nearly all traditional functions of the international health system. In 1990, WHO mobilised nearly US$1.2 billion of a total of US$5.6 billion development assistance for health (DAH) (Ravishankar *et al.*, 2009). This was

significantly more than any other bilateral or multilateral institution. Within a few years, however, the landscape would shift considerably, driven in no small part by the global AIDS movement.

With over 3 million people contracting HIV annually at the time, UNAIDS was established in 1996 to bridge the activities of several UN agencies. The following year, researchers announced that various antiretroviral drug combinations offered hope as an effective treatment for people living with HIV. Thousands of Americans and Europeans gained immediate access to the new therapies with a Lazarus effect: in the face of imminent death, men, women and children regained healthy, productive lives.

Yet while treatment was a miracle to those who could afford it, it also revealed a deep social injustice: millions of people in poor countries were left to perish due to the prohibitively high costs of patented drugs. In an unprecedented expression of global solidarity, people living with HIV, activists, scientists, governments and international organisations overturned the status quo. The resulting 'Doha Declaration' reaffirmed flexibilities in the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) in circumventing patent rights in support of people's struggle to survive. The Declaration enabled generic competition and ultimately led to a dramatic increase in the number of people on HIV treatment in LMICs – and estimated cost savings of US$325 billion to date (Figure 19.1).

Figure 19.1. *Total cost of antiretroviral therapy (ART) with and without price reductions*



Note: * June 2014.

Source: UNAIDS (2014).

The urgency of AIDS activism fuelled the spectacular rise of health on the global political agenda. In 2001, the UN Security Council debated its first health issue – HIV. Global health became a core agenda item for the G8, which led to the establishment of the Global Fund to Fight AIDS, Tuberculosis and Malaria ('Global Fund') in 2002. In the same year, the World Economic Forum

established its Global Health Initiative and in 2003, PEPFAR was launched which was to become the largest bilateral assistance programme ever.

With year-on-year increases in DAH of over 10% from 2001-10, the 2000s have been dubbed the 'golden era of global health' (IHME, 2014). Annual DAH grew more than five-fold between 1990 and 2013, from US$5.2 billion to US$31.3 billion. However, DAH still represents less than 1% of what donor governments spend on health in their own countries (IHME, 2014). New resources ushered in a wave of institutional creation overwhelmingly focused on infectious disease and maternal and child health. About one-fifth of DAH now originates from or is channelled through new private and public institutions that did not exist in the early 1990s, including the Global Fund, the Gavi Alliance, UNAIDS, UNITAID and the Bill and Melinda Gates Foundation. Resources generated by US NGOs from private philanthropy also account for an important and growing share of DAH.

New world order, shifting development paradigm

The explosion of new institutions and partnerships active in global health has occurred in parallel with the rise of several middle-income countries. Domestic revenues in the developing world reached US$7.7 trillion in 2012, having increased on average by 14% per year since 2000 (UNDP, 2014). LMICs are driving global economic growth and now absorb more foreign direct investment than high-income countries (World Bank, 2013). In 2012, developing countries held 46% of global savings; by 2030, this share is predicted to rise to 62% (World Bank, 2013). This implies that future foreign investment will also increasingly emanate from the developing world. This fundamental geopolitical shift has brought increasing multipolarity to the global system, with several implications for global health financing.

Some emerging economies are increasingly able to finance their domestic health needs – including HIV treatment, which was considered unaffordable only a decade ago. South Africa, for example, quadrupled its domestic investment in HIV between 2006 and 2011, and the government has resolved to provide antiretroviral therapy (ART) free of charge to at least 80% of people eligible for treatment by 2015 (UNAIDS, 2013a). Furthermore, several middle-income countries have become important international development partners, establishing a new paradigm focused on a model of mutual benefit and sustainability rather than aid and chronic debt (Mwase and Yang, 2012). In part in response to the perceived financing monopoly and unrepresentative governance arrangements of the Bretton Woods institutions, the BRICS countries (Brazil, Russia, India, China and South Africa) recently agreed to each contribute US$10 billion to establish their own financing institution – The New Development Bank.[2]

Middle-income countries are also increasingly engaging in transfers of technology, private investments and other types of South-South cooperation, which reached concessional flows estimated at US$16-19 billion in 2011

2 Fortaleza Declaration, 6th BRICS Summit, 15 July 2014 (http://pib.nic.in/newsite/PrintRelease.aspx?relid=106712).

(ICESDF, 2014). They are also recognising global health as a form of soft diplomacy and a gateway to political and economic alliances.

Simultaneously, unprecedented economic growth across Africa is accelerating a concerted drive for African-led development and regional integration. In 2012, the African Union endorsed its *Roadmap on Shared Responsibility and Global Solidarity for AIDS, Tuberculosis and Malaria in Africa* (African Union, 2012). The Roadmap promotes African-owned solutions to change the trajectory of AIDS and development on the continent across three pillars: diversified financing, access to medicine and enhanced governance. The transformative discourse employed by emerging economies gives weight to the claim that a paradigm shift in global health is underway (Harmer and Buse, 2014).

In practice, development cooperation has represented a very small proportion of GNP in middle-income counties for some time. In lower-middle-income countries, DAH accounts for only 2.7% of health expenditure, and 0.2% in upper-middle-income countries. This has enabled greater economic independence from major donors, as countries are able to mobilise more domestic resources and access private capital markets.

Despite impressive economic growth, many emerging middle-income countries continue to struggle with large impoverished populations, growing economic and health inequality and weak social protection systems. While the number of multi-millionaires in India has nearly doubled since 2011 to reach 117,000 (Kotak Wealth Management, 2014), one-third of the population continues to live in poverty. Thus, as some OECD countries are reducing or phasing out assistance to middle-income countries, questions remain about what income status means for any particular country's capacity, and that of its institutions, to protect and promote health and to combat poverty and vulnerability (Glennie, 2013). The picture is radically different for low-income countries, where external financing accounts for nearly 26% of total health expenditure. The shortcomings of DAH hit low-income countries hardest (Moon and Omole, 2013).

As the international community surveys the implications of a rapidly transforming world, there is a universal sense of frustration with the failure to translate aid into sustainable outcomes and to enable a true culture of country ownership, accountability and global solidarity.

4. Grand challenges in global health financing

The MDGs were unprecedented in bringing together political leaders and inspiring them to collectively commit to a single set of development goals. During the MDG era, we have witnessed a burgeoning of new forms of global solidarity, much of it driven by the AIDS movement, particularly through novel public-private partnerships and innovative financing mechanisms.

Yet the global health financing paradigm remains centred on the basic assumption that one part of the world has money and the other part has problems. 'Development' as a process occurs largely within the boundaries of nation states – with aid representing a short-term transfer based on the premise that, once the poor 'catch up' (or converge) with the rich, it will no longer be needed.

This paradigm reflects an era before the advent of global social movements for development. It harks back to a time before novel partnerships with the private sector, instantaneous global communication and endless capacity for knowledge sharing.

Unsurprisingly then, this 20th century global health financing paradigm is plagued by a number of weaknesses.

Insufficient funds

Existing levels of global health financing are inadequate (Moon and Omole, 2013). Every year, the right to health of 1.3 billion people is limited by their inability to make direct payments for health services. Despite rapid progress, 22 million people living with HIV are still in need of treatment. DAH for maternal, new-born and child health has increased more than any other area in the last few years, yet spending per live birth remains only US$51. NCDs are perhaps the most neglected and underfunded. Despite accounting for more than half of the global burden of disease, NCDs receive only 1.2% of total DAH (US$377 million).

Sovereignty versus collective action

With growing appreciation of the value of global public goods as well as the intensification of transfers of health risks across borders, countries must agree on their respective rights and responsibilities and the contours of effective international collective action. Progress is thwarted by the unequal distribution of health risks, opposing interests and values of various actors, and the unequal and rapidly evolving distribution of power among countries. National sovereignty often undermines transnational coordination for global health financing in the absence of strong accountability mechanisms (Frenk and Moon, 2013).

Poor coordination

The proliferation of actors involved in DAH has raised concerns regarding the lack of coordination among them. The total number of major global health actors was estimated to be at least 175 in 2008 (not accounting for the thousands of active NGOs) (McColl, 2008). Poor coordination can result in inefficiency through duplication, policy confusion, high recipient country administrative costs, and infringement of recipient sovereignty through the displacement of local priorities (Buse and Walt, 1996). Furthermore, the lack of a common systematic approach can exacerbate health inequalities by favouring specific diseases, populations and countries.

Dependence on external sources

With the United States contributing 24% of total DAH, and the Gates Foundation contributing another 7-8%, significant power is held in few hands. This renders global health financing vulnerable to the political vagaries of a deeply divided US Congress and the interests of a single family. The case of AIDS is particularly acute: while domestic spending has significantly increased in some LMICs, over

80% of HIV funds in low-income countries and 73% of HIV funds in lower-middle-income countries originate from external sources (UNAIDS, 2013b).

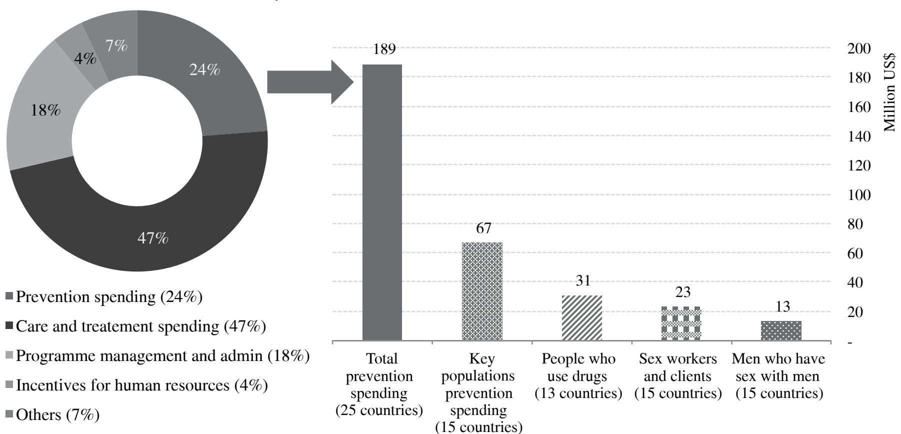
Volatility and uncertainty

Foreign aid is notoriously unpredictable, undermining long-term planning and value for money (ICESDF, 2014). When aid to countries is volatile, its value is reduced by 15-20% (Kharas, 2008). While aid flows for health are increasingly funding recurrent costs such as drugs, salaries and transport, the accessibility and channels for disbursement of DAH are poorly suited for such costs. DAH volatility is particularly acute in aid-dependent countries, with direct implications for the financing and delivery of primary healthcare services (Lane and Glassman, 2009).

Inequity

Recent food, economic and climate crises demonstrate that economic growth is only part of the solution. Poverty and poor health should be increasingly defined in terms of vulnerability and inequity. On the flip side, progress should be defined through results and resilience. The AIDS epidemic reveals profound inequalities and discrimination within societies, and the misalignment of financing to needs. The fastest-growing epidemics in Asia and the Pacific are among men who have sex with men (MSM), yet they receive little focus in terms of programmes and services. Even in countries with rising HIV prevalence among MSM, investment for HIV prevention among this group is only 7% of total prevention spending (Figure 19.2). Vulnerable populations in general are often the most marginalised from health services; in the US, for example, the new federal health care law does not provide any health insurance to the 11 million undocumented immigrants in the country (OWG, 2014b).

Figure 19.2. *AIDS spending in Asia and the Pacific by major spending categories and prevention spending on key populations, latest available year, 2009-2012*



Source: Prepared by www.aidsdatahub.org based on www.aidsinfoonline.org.

Limited impact on sectors outside health

Health is increasingly the product of policy-making processes and actions initiated in multiple sectors. Yet the majority of efforts to promote health continue to operate in the realm of services delivered by the health sector and fail to confront the social, political, economic and environmental factors that contribute to poor health and health inequity. The potential for health financing to catalyse change across the determinants of health and support people to make healthy choices remains unfulfilled.

Weak accountability

As a function of institutional deficiencies at both the national and global level, in many areas of external health financing, accountability to people is undermined by several factors. These include: the channels of accountability, namely of international organisations to their member states and of recipient countries to their donors; lack of transparency in how funds are allocated at both the global and national level; and weak community oversight capacity. In particular, mechanisms to hold non-state actors accountable in global health financing are lacking. Such actors include pharmaceutical companies, private foundations and private health services providers, which play an increasingly influential role in global health.

Inadequate investment in preparedness for future threats

Jeffrey Sachs cautioned that the world is not ready for Ebola, or any other new lethal pathogen (Sachs, 2014). He flagged the recent stagnation in international aid for health, the lack of even basic health systems and community health workers in poor communities and countries, inadequate R&D for infectious diseases and limited investment in global disease surveillance. These severe shortages, coupled with the dizzying movement of people and goods, combine to create a systemic vulnerability to future outbreaks. We are, he concludes, wholly unprepared for the growing number and scope of health threats likely to arise – in terms of financial capacity, delivery systems, community mobilisation and more.

5. Towards a global compact for health

In the face of such vulnerability, a novel global health financing approach is urgently required.

The scope of global health is evolving – from the health of poor countries to the health of the global population. This evolution is occurring as part of a larger conceptual shift in development, from a focus on poverty reduction in 'poor countries' to sustainable development in all countries, regardless of national income level. It is a shift towards leaving no-one behind through ensuring global solidarity, and implies shared responsibilities, duties and obligations as well as shared resources (Frenk and Moon, 2013).

Challenging the status quo is never easy. Yet, when we survey the continued failures of global health financing to enable people to realise one of their most

basic human rights – the right to health – we must not only *challenge* the status quo, we must *overturn* it.

Although robust domestic policies must remain the focus as the long-term drivers to end poverty and drive sustainable development for health, the current approach to mobilising, channelling and allocating DAH must be modernised. This is not to say that DAH should be reduced. Several countries – particularly low-income, fragile and post-conflict ones – will continue to rely on traditional aid for many years to come.

Yet for most countries and communities, a fundamental shift in our approach to health financing is required. As the Intergovernmental Committee of Experts on Sustainable Development Financing highlights (ICESDF, 2014), we must move towards a more nuanced partnership among countries based on common but differentiated responsibilities and global solidarity; towards sources that are more diverse and less volatile; and towards significantly more political commitment to and investment in reshaping the determinants of health. This will foster resilience among the poorest and most vulnerable populations and build healthier, more equitable societies. The AIDS movement has shown what is possible through global solidarity. Let us learn both from our triumphs and failures in the response, and build on its success in fomenting a global compact for health financing.

A global compact for health: Three dimensions

The building blocks of such a compact are already at the heart of global policy. Elements include the Universal Declaration of Human Rights, the MDGs, global definitions of minimum standards of decent life, wide political support to establish a global social protection floor, and the reinvigorated push for universal health coverage. Furthermore, communication technology, travel and migration are decreasing the social distance between communities worldwide and creating new opportunities for global solidarity and citizenship.

A global compact for sustainable heath financing should comprise three dimensions.

1) Solidarity for ending vulnerability and building resilience through a Global Health Equity Fund

The establishment of a Global Health Equity Fund, or the evolution of current institutions to fulfil this function, will solidify a global compact for health financing. Such a fund would increase the availability of total financing by encouraging both the engagement of new partners and the uptake and expansion of innovative taxation to raise funds for health (for example, excise taxes related to tobacco, alcohol, sugar and carbon emissions). It would expand the scope of existing mechanisms such that the most marginalised and impoverished in all countries benefit from global solidarity.

Existing financing mechanisms are well placed to evolve into such an equity fund. Such a mechanism could provide large-scale international public finance to underpin the structural and social transformations needed to move

towards a socially just and healthy future, pooling funds drawn from countries of all income levels, individuals, foundations and the private sector and those generated through innovative financing mechanisms. It could perform a number of functions, including:

- redressing inequalities in the distribution of health financing across and within countries and populations;
- subsidising national costs of universal programmes for health and social protection (including for the poor in middle-income countries);
- building countries' capacity to increase tax revenues and domestic resource mobilisation;
- providing catalytic funding to support more inclusive societies through investing in civil society and community systems, strengthening and equipping communities to demand services, policy change and political accountability;
- responding quickly and coherently to serous outbreaks as they arise – including contingencies for surge capacity, bypassing the time-consuming need to approach multiple donor countries; and
- financing global public goods for health, including innovation and R&D that meet the needs of poorer populations.

The fund would also help to fulfil the call made by the ICESDF for an enabling international environment that reduces fragmentation, complexity of international public finance and administrative costs. This ensures that existing funds go further and that rules for international public funds are simplified and harmonised (ICESDF, 2014).

Investment in social protection makes both political and economic sense: such investment has been demonstrated to promote fairer distribution of opportunity, inclusive economic growth and, ultimately, more resilient and secure societies. Basic social protection is affordable: an estimated 2% of global GDP would provide the world's poor with a minimum package of social benefits and services (ILO, 2006).

Inequalities in the distribution of health financing between and within countries and populations have arisen as a function of poor coordination as well as political interests. The Global Health Equity Fund would provide a critical mechanism to reduce and redress such inequalities – a missing link in today's health financing system.

While the consolidation of existing mechanisms into a global health 'superfund' will require significant consideration and negotiation to address the associated political, institutional and legal issues, in the medium term there is a case for merging major pooled funds such as GFATM,[3] Gavi,[4] UNICEF,[5]

3 The Global Fund to Fight AIDS, Tuberculosis and Malaria.
4 The Vaccine Alliance.
5 The United Nations Children's Fund.

UNFPA[6] and UNITAID and, in the more immediate term, a case for harmonising their procedures to support countries more coherently.

2) Global citizenry to demand rights and accountability

At the heart of the activism that sparked the AIDS movement was a common sense of outrage and urgency, as well as belief in the value of human dignity and the power of collective action. Citizen participation driven by the shared values of human rights, inclusion and equality must form the backbone of a global compact for health.

Global citizenship is often viewed as an element of 'cosmopolitanism', which envisions a single global community built on shared values. In this community, citizens engage as they would in their local or national communities, each fulfilling their duties to the betterment of all but with new, globally extended consideration and respect. To address criticisms of cosmopolitanism, global health citizenship should build its framework at the local and national levels, making use of existing institutions and maintaining a sense of immediacy crucial to notions of shared responsibility and community.

A global citizenry is empowered to claim their rights to health and to demand action and answerability from decision-makers. Yet membership is not guaranteed without an accompanying responsibility for the health of fellow members of society – from environmental and resource protection, to financial contribution and universal health care services. As Benatar *et al.* (2003) warn, 'the conceptual logic of rights entails corresponding duties. […] If all claim rights but none is willing to bear duties, rights will not be satisfied.'

The post-2015 debate presents an opportunity to agree cosmopolitan principles for an agenda that places the global health citizen at its core. We must grasp this opportunity to galvanise three critical shifts.

- *From 'beneficiaries'/'consumers' to active change agents*. To reflect such a shift, the planning model is transformed from a top-down approach to one driven by people: the 'democratisation of problem-solving'. This means empowering people to manage health in different ways. As Amartya Sen asserts, agency is a person's ability to pursue substantive freedoms, and therefore allows an examination of whether economic, social, and/or political barriers impede those freedoms. Furthermore, concern for agency stresses that *participation*, public debate, *democratic* practice, and *empowerment* must be fostered alongside well-being – all areas that require scaled-up and reliable investment across communities and countries.

- *From individual to collective responsibility.* In many countries, we see threats to citizenship posed by growing inequality and by the aspirations of the middle classes when the prospect of wealth blinds them from obligations to other members of their society. These global health citizens must take individual and collective responsibility for the well-being and sustainable future of people and the planet.

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6 The United Nations Population Fund.

- *From elite, closed-door decision-making to legitimate global governance*. A social compact involves not only social welfare, but also the consent, engagement and representation of the governed, providing legitimacy and authority to those who govern (Moon, 2014). Governing a global compact in the 21st century will require changes in norms and decision-making processes, as well as the effective use of modernised accountability mechanisms. Such mechanisms should be built on new forms of social media that leverage interconnectedness, transparency and communication and thereby facilitate effective representation (ICESDF, 2014).

Obtaining financial and political support for the realisation of these three shifts at the global *and* the community level is critical. Fully engaged community members and the decentralisation of service delivery brings services closer to the people who need them and cultivates trust – an essential element in the health system. This in turn facilitates access, adherence, health literacy and community leadership to implement innovative, local solutions.

3) Global regulatory framework to mitigate vulnerability and inequality

The unacceptable health inequities within and between countries require global political solutions. Multinational corporations, in particular, have significant influence over global consumption of food, tobacco, pharmaceuticals and health care. While these goods and services pose health hazards that span national borders, powerful transnational companies often operate outside the jurisdiction of national law.

Despite action and interest in the power of international rule-making for health over the last few decades, significant and grave threats remain under-regulated at the international level (Moon, 2014). International trade and intellectual property laws affect the ability of LMICs to ensure access to medicines. The 'push and pull' of market forces have resulted in the heavy migration of doctors and nurses to high-income countries, leaving the poor without adequate human resources for well-functioning health care systems.

A global compact for health must be built upon and push forth a cross-sectoral, political agenda that seeks to establish transnational institutions (including treaties, funds, courts, and softer forms of regulation such as norms and guidelines) to ensure the quality and safety of goods and services that travel in international commerce.

One such proposal gaining political traction is a legally binding global health treaty – a Framework Convention for Global Health (Sidibé and Buse, 2012; Gostin *et al.*, 2013). Such a framework would establish global norms and articulate the duties of states to ensure access to a full range of services, as well as empowering civil society to litigate the right to health. Furthermore, a robust treaty on health would significantly strengthen its position in the face of other legal regimes, such as trade and investment, requiring other international bodies and countries to refrain from taking actions that might undermine the right to health.

6. Close: Forging a movement for a global compact in a post-2015 world

In a rapidly evolving global context, the very fabric of health is shifting. The factors that determine ill-health, vulnerability and access to services are at once global and local, private and public. And yet the architecture and financing mechanisms in place to address health do not reflect the full complexity and interdependency of these drivers. Furthermore, our capacity to anticipate and foster resilience to respond to future health threats remains an urgent concern. In short, there is a widening gap between our understanding of how to create sustainable health for all and the capacity of the existing global health architecture to finance and deliver it.

The post-2015 health agenda as it is currently conceived is even more ambitious than the heath MDGs and will require both a significant increase in investments in health and an expansion in their scope. To harness the investment potential for health of an increasingly wealthy world, it is imperative to build up the domestic resource base and better engage new players, while enhancing accountability of traditional donors to meet and scale-up their contributions.

The post-2015 agenda provides the opportunity we need to transform global health by securing a global compact for sustainable heath financing. Such a compact must be built on three pillars: solidarity for ending vulnerability and building resilience through a Global Health Equity Fund; a global citizenry to demand rights and accountability; and global regulation to dismantle the transnational determinants of vulnerability and inequality.

Ultimately, the success of such a compact will rest on a collective recognition that to democratise opportunity and elevate the poorest and most vulnerable among us is to create a better future for all. Now we must break free from the issue-specific silos that continue to limit too much of our work, and join together in a broad movement to deliver a truly transformational compact.

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20

Development Partners, One More Push for Greater Impact!

Jean-Michel Severino and Pierrick Baraton

1. Despondent (but still enthusiastic)

This is a tale of disappointments and enthusiasm, inextricably intertwined with each other.

The financial mechanisms established to meet public interest needs have continued to diversify over the last 20 years. This diversification has affected official development assistance (ODA) in three ways: upstream, in terms of seeking new methods of fundraising; downstream, with a huge diversification of uses; and finally, laterally, with the diversification of development agenda objectives, and the emergence of problems in terms of managing globalisation and the concept of global public assets.

The reasons for this diversification are well known: doubts as to the effectiveness of 'traditional' ODA, budget constraints, trends in global public needs and the technological revolution. All have resulted in a pushing of the boundaries of the imagination, and in a transformation of the operational and instrumental mechanisms for global policy-making.

In this innovative work, the microeconomic ground has proved particularly fertile. The reasons for this expansion, however, are to be found in a four-fold, paradoxical disappointment.

First, disappointment in macroeconomic terms. The macroeconomy has reigned supreme in development economics and ODA since the 1980s, jettisoned to the forefront of concerns by Latin American and African structural adjustment. Although it continues to play a fundamental role in establishing efficient trajectories of growth for developing economies, it is unable to address a significant number of issues relating to the quality of that growth, including, for example, ensuring that African growth delivers more jobs. This issue does not fall within the remit of macroeconomics, and the cost of labour, for example, is quite incapable of responding to this immense challenge. Such a response lies in the structure of the economy, and particularly in its capacity to generate job-creating entrepreneurial fabric.

Second, disappointment in terms of the state. Project-type interventions have, for a number of decades now, been the only response to the challenge identified above: creating programmes for small and medium-sized enterprises (SMEs), establishing departments devoted to this issue and releasing public funds through

specialist institutions. While these intervention methods have their place, they cannot themselves 'enter the market'. This disappointment reaches to the very heart of the historic public service mission: education, health among others, and even security. Everywhere, initiatives are emerging with the aims of providing care, child nutrition or improving access to energy via alternative channels situated within the market itself and not just on its periphery.

Third, disappointment with markets. The one thing that all impact investment actors agree upon is criticism of the rules of the dominant party in market capitalism: questioning the role of shareholders and company owners, challenging profit maximisation as the only guide to investment decisions, criticising the short-term outlook of the market, and recognising its inability to provide essential goods and products to the poorest of the poor. The market's capacity to spontaneously create collective well-being is also being challenged.

Finally, disappointment with charitable action too, and historic forms of NGO activity. Sixty years of international humanitarian action have demonstrated the need for, but also the limitations of, emergency aid, while development NGOs are also facing the challenge of ensuring the financial sustainability of the actions they support. A growing number of civil society actors involved in development work are in the grip of donor fatigue.

All these disappointments clearly require us to imagine an alternative path, but what might this be? We need to retain company or financial actors as the essential engines for producing well-being in a competitive situation. We need to find an economic model that will bring about long-term financial sustainability but give meaning to activities by ensuring that they contribute to well-being through the achievement of specific objectives in terms of social, environmental, ethical and political impacts.

This research is taking place in an impressive climate of entrepreneurial enthusiasm, enabling a spirit of enterprise, creativity, innovation, freedom and the room for manoeuvre offered by economic independence to be combined with the search for public interest. It is resulting in a growing number of operational and financial innovations, of which 'impact investment' is one of the most successful and rapidly growing forms.

2. Did you say 'impact investment'?

2.1. Profiles and motivations

What kinds of people are involved in public interest innovation in the market, and what do they do? Well, they can broadly be divided into two large categories:

- *Those proposing alternative forms of market enterprise*. This sector consists essentially of promoting business ownership in forms other than shareholding; the company may, in fact, be owned by its customers, its suppliers or its employees. Operating under a number of different ownership systems, these companies may have strict performance targets, as is the case for a large part of the cooperative movement. They may, however, be based on a specific values system, promoting the collective

interest, or even have explicit public interest objectives. They are then clearly located within the 'social business' or 'social entrepreneurship' world. In what follows, however, we will use the term 'societal' rather than social as, strictly speaking, this has greater connotations of the human development agenda (health, education, etc.).

- *Those wanting to use classic economic models but amending some of their features,* for example performance expectations, in order to try and take account of the externalities related to these activities. They are aimed at 'patient' investors, and include in their approach an extra-financial return on their investments. When this relates to companies producing goods or services aimed at meeting a public interest need, these actors are also known as 'social businesses'. They are not generally aimed at making a profit and, if they are, it is only a marginal one and clearly below market expectations. The term 'social impact business' is used when the drive for profitability remains explicit despite the company's clear vocation. When this relates to financers (banks, investment funds, etc.), they are called 'impact investors'. These latter companies are the focus of this chapter.

Impact investors are often the funders of social businesses. They see value in being able to provide their resources to companies with a public interest mission, in the context of a private initiative, providing they are able to at least cover the costs of the financial arrangement.

However, they have a much wider social and economic scope. The aim of impact investing is not, in fact, defined by the legal nature, or even by the level of profitability, of the investment goals but by the expected impacts. In many cases, these impacts can be obtained by financing traditional players in the market economy who are facing obstacles in securing funding due to a weakness or limitation in the market.

Let us look at a few examples. When the International Finance Corporation (IFC) and the Gates Foundation join forces to create an investment fund devoted to health, if the stated aim of their joint venture is to have an impact on health indicators then they can claim to be impact investors, even if the fund does show a degree of profitability and invests in private for-profit companies such as hospitals and pharmaceutical companies. When Investisseurs et Partenaires (I&P) invests in SMEs in Africa that have no market access, and in a niche where profits clearly exist but are below those expected of emerging markets, the description of impact investor also applies. The spectrum of such impact investments, as well as the level of profitability of the activities, can therefore be extremely wide and operational methods may also be very diverse.

Impact investors do not fall under the heading of 'socially responsible investors' (SRIs). This term in fact applies to those investing in publicly listed companies, and who apply criteria of social, environmental or ethical responsibility to their buying and selling decisions. These SRIs do sometimes actively use their voting rights in general meetings or their significant share in the long-term debt of

companies to put pressure on their investment targets and encourage them to change their behaviour. This approach has been seen taking hold more recently in unlisted activities.

These impact investors clearly need to find investors or shareholders. In organic terms, as private equity funds or traditional financial companies, they are no more than intermediaries between savers and users. So who is behind these fast-growing entities? We shall discuss this in further depth below.

2.2. Background to and identities of impact investors

Historically, the movement first took off around the end of the 1990s. It found its first funders in the world of 'family offices', foundations specialising in the promotion of entrepreneurship, and in some companies. Some development finance institutions (DFIs), such as Proparco or the EIB, dipped their toes in the water and contributed to the emergence of the sector. However, the range of impact investors has gradually grown in four directions, as we shall see below.

We now find states and public actors involved. They increasingly see this area as an effective way of supplementing the traditional aid instruments and are now pushing their specialist financial institutions to support the emergence of this sector. The G8, under the UK presidency, established a taskforce in this regard, led by Sir Ronald Cohen, which published its report in September 2014 (Social Impact Investment Taskforce, 2014). In particular, the group called for the increased participation of official development financing actors in impact investment. This represents a new opportunity for public actors to contribute to achieving global objectives of sustainable development by limiting donations and further improving the effectiveness of aid.

Foundations are proving to be increasingly dynamic players in the sector. They have contributed greatly to its emergence, perhaps somewhat paradoxically, by providing grants, implementing technical assistance programmes or financing sector organisations. The Rockefeller Foundation, for example, has been a driving force in the promotion of federations of impact investors such as the Global Impact Investing Network (GIIN) or the Aspen Network of Development Entrepreneurs. The European foundations have played a major role in the take-off of the European Venture Philanthropy Association (EVPA). Few of these foundations, however, have dared to finance impact investment actors directly, as has been the case for example of the 'Lundin for Africa' Foundation, which specialises in promoting African entrepreneurship. This trend is likely to change following the introduction of 'programme-related investments' (PRIs), which are enabling a growing number of these foundations to invest their resources with the aim of obtaining a moderate financial return in areas that are consistent with their mission.

The traditional financial sector is taking its first steps into this area. Traditionally, it has been reticent about investing in unlisted activities, and even more so in private equity activities. Socially responsible investment, which has grown considerably right across the world, is thus almost exclusively focused on the bond markets. However, we are now seeing a growing trend among large

institutional investors for the appearance of budgets devoted to impact investment. The entry of mass actors, such as pension funds, although not yet occurring on a large scale, would lead to a massive change in the sector's financing.

Finally, industrial companies have been very active in the sector. Some, such as Danone, Schneider, Unilever or Suez, are among the oldest impact investment players, including those with particularly social visions. For these large groups, investing a share of their cash flow in market activities with a societal aim is in line with their desire to resolve strategic problems related to their long-term sustainability, such as climate change and natural resource degradation.

3. Different kinds of impact investment

So when we talk about a boom in this kind of investment, do we mean on the scale of the Vatican City or the Soviet Union?

The impact investment sector is still in its early stages. Exhaustive evaluations of its development are few and far between. Different definitions result in significant variations in the estimates of its size. For example, KPMG Luxembourg estimated that the 1,775 responsible investment funds (including impact investment) represented an invested total of €238 billion in Europe in 2012 (KPMG, 2013). According to Eurosif, the total amount invested by impact funds in Europe over the same period was likely to be €8.75 billion (Eurosif, 2012). Such a variation in results highlights the fact that there is still no common definition of impact investment, and caution is therefore advisable when analysing these figures. It is still more difficult to distinguish within these sums the amounts invested in OECD countries and those destined for the developing world. Impact investment is, in fact, first and foremost a European and North American movement focused on domestic issues.

On the basis of the last annual survey conducted among 126 impact investors by GIIN and JP Morgan, this category represented US$46 billion of assets under management in 2013 around the world, of which 70% was in emerging countries (Saltuk et al., 2014). A total of 4,900 investments have apparently been made this year alone, involving an amount of US$10.6 billion, a figure that is likely to increase by 20% in 2014.

According to the same survey, investments are likely to increase in sub-Saharan African (which represents 15% of assets under management, or US$6.9 billion) and in South-East Asia. These investments are largely focused on the microfinance sector, which represents 21% of assets managed, with the financial sector (excluding microfinance) standing at 21%, energy at 11% and housing at 8%.

These trends are comparable to those we are observing in traditional investment capital. According to EMPEA (2013), US$24 billion was invested in the emerging countries in 2013, with 883 investments made. Sub-Saharan Africa still 'only' represents 7% of this total (US$1.6 billion invested in 2013), but it is the most dynamic region, with 43% growth in investments compared with 2012.

This upward trend must be seen in the perspective of the trend in ODA. This has fallen 6% in real terms since 2010,[1] under the effect of budget tightening, but aid flows still stood at US$136.4 billion in 2012 (World Bank, 2014), of which US$47.4 billion were destined for sub-Saharan Africa. It can therefore be seen that impact investment is far from replacing ODA; it is, and will remain over the decade to come, an important supplement enabling a number of challenges to be addressed that historic forms of international solidarity have been unable to resolve.

4. So what is it, essentially?

At this stage in our discussion, it is useful to consider precisely what contribution impact investment can make to both ODA and NGO actions, and this brings us back to the need to establish a definition of the concept and its variations.

4.1. Current definition lacks clarity

Ascertaining the primary aim of impact investment has been a topic of much debate among those involved. Initially perceived as a way of funding the social and solidarity economy, i.e. companies based on a principle of solidarity and societal utility, the concept has grown as the practices have diversified.

Although the term has been around since 2007, its definition still remains imprecise. Considered as a form of investment that seeks to combine financial return with societal impact, it sits at the junction between the concepts of SRI, social investment, 'venture philanthropy' and even social entrepreneurship.

This profusion of terms bears witness to the current infatuation of private and public actors with valuing the societal dimension of projects financed. It also attests to the difficulty in identifying the distinctive features of this now burgeoning sector of the economy.

The GIIN, which represents most global impact investors, has devoted a great deal of energy to establishing and gaining acceptance of a definition. This definition is based on three features: the *intentionality* of investors to generate social and environmental impacts, the *coexistence* of the company's financial profitability and impacts, and the concept of *social impact* and the *need to measure this*.

If taken broadly, however, these three factors are insufficient to establish a clear standard definition of impact investment. According to these three concepts, one could actually argue that all companies (and thus their investors) form part of this sector, provided they define their aim in terms of impact. In fact, a profitable business also has social impacts: it generates well-being among its customers and can improve their standard of living, it directly creates jobs and indirectly contributes to creating jobs among its suppliers, and as it is profitable, there is good coexistence of the two objectives. Finally, all investors have the

1 http://www.oecd.org/fr/cad/stats/le-decrochage-de-laide-aux-pays-pauvres-se-poursuit-a-mesure-que-les-gouvernements-serrent-la-vis-budgetaire.htm.

aim, explicit or not, of creating jobs in addition to making a profit through their investment.

This example demonstrates the need to complete this definition by clarifying the concept of societal impact and specifying how the concepts of intentionality and coexistence are linked, particularly through the notion of 'tradeoff'.

4.2. What does 'societal impact' mean?

Impacts can be defined as long-term changes affecting all stakeholders and which are directly attributable to the project's activity. Impacts are thus multidimensional by nature and are created by all companies, whether they form part of the 'impact investment' sector or not. The addition of the adjective 'societal' stems from the desire to distinguish a certain kind of impact by highlighting its utility to society.

However, discerning the societal utility of a project is difficult given that there is no consensus around a definition of this concept. Euillet (2002) defines societal utility as the 'characteristic of any service responding to needs that are not or are insufficiently covered by the state or the market'. Other authors, such as Gadrey (2004), define it according to several dimensions, particularly the process of producing a product or a service more effectively for the community or of fighting exclusion and inequality.

Job creation, for example, is an impact often claimed by impact investors. But this impact, if it is actually a concrete contribution to poverty reduction, is shared by all companies. The notion of societal impact, although necessary, is therefore insufficient to distinguish those involved in the impact investment sector. In order to judge the societal nature of a company, and thus of an investor, in a generic area such as jobs, you need to be able to compare their 'impact performance' in the light of other actors in a similar sector.

Although not impossible, distinguishing the role of the impact investor in relation to the traditional financial investor therefore seems complex given the lack of any performance standards that would enable the impact of a company to be compared with what is 'normally' expected of a company. The poor discriminatory power of the use of 'societal' as an adjective, along with the lack of an impact standard, highlights the need for the concept of tradeoff.

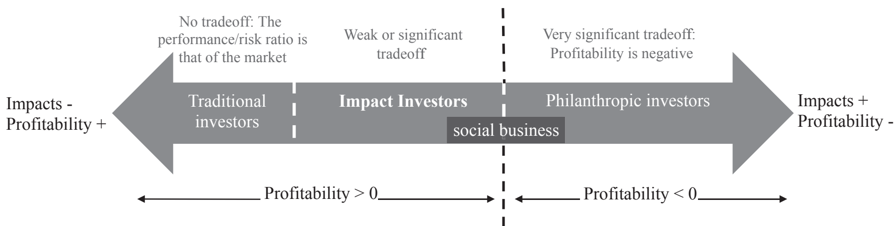
4.3. The importance of the concept of tradeoff

Unlike a 'traditional' investor, the impact investor sets himself an impact objective in addition to his financial objective, and this is taken fully on board in the running of the company. To achieve this objective, the company must mobilise resources that will thus no longer be available for profit maximisation. Because these resources are, in essence, limited, it becomes necessary to prioritise profit and impact.

The company may decide to maximise its impact, subject to achieving a minimum level of profitability. It may, on the other hand, decide to maximise its profit, subject to having achieved the impact objectives that were set. The first case describes a logic that is often described as 'impact first': having the maximum impact (the greatest social utility) subject to achieving a certain

profitability to ensure sustainability. The second case is often described as ‘finance first’: aiming to retain an economic logic of maximisation while optimising the impacts created. In reality, as you can imagine, the boundaries between the two can be blurred, depending on the level of profitability that the ‘impact first’ investor sets himself, and the nature of the impact that the ‘finance first’ investor chooses. Yet this distinction remains interesting both in terms of describing the set of preferred choices in each of the situations and, above all, for the actors themselves, insofar as the choice of one or other of the two logics governs the way in which they structure their economic model.

Figure 20.1. *Mapping of investors according to tradeoff between profitability and impacts*



Projects with high social utility involve a lower profitability/risk ratio than other investments with less social impact. This could be because resources that need to be mobilised to achieve the impact objective are no longer available for profitable investment, or the macroeconomic context in which the project is embedded is more risky, or even because – due to its very essence – the project generates poor gross margins. Prioritising a specific impact by investing in it thus involves, at least in the short term, foregoing part of one’s profitability.

The lower profitability of these projects may result in funding difficulties. The intentionality of the impact investor is thus characterised by his willingness to accept profits below market levels in order to prioritise the extra-financial impacts that are specifically not taken into account by traditional investors. This renouncing of profitability to the benefit of social utility, without abandoning the logic of economic efficiency in the company’s management, is characteristic of an impact investor.

5. What is impact?

Balancing profitability and impact assumes the ability to measure both. Assessing financial profitability is already, in and of itself, a misleadingly easy task, and that of societal profitability all the more difficult. The sector’s maturity in this area still seems very poor and conveys a feeling that one is still very far from the ambition of Confucius when he said, ‘[r]eal knowledge is knowing the extent of one’s ignorance’.

5.1. The need for a better understanding of the concept of impact

The terms 'effects', 'impacts', and even 'outcomes' are often used interchangeably by impact investment actors to denote the consequences of a project. However, each of these terms has its own specific meaning. *Outcomes* denotes things that are directly generated by an action. These outcomes have short- and medium-term consequences – positive or negative, direct or indirect, intentional or not – and these are the project's *effects*. The project's *impact* is thus the long-term effect that is directly attributable to the project.

These notions are therefore not synonymous and to confuse them can result in important misunderstandings. Their often interchangeable use by impact investors can be explained not only by the youth of the actors, but also by a misunderstanding of the different definitions and the convenience of the term 'impact'. Above all, however, it is due to the difficulty in accurately assessing a project's impacts.

Among investors, an evaluation of 'impact' thus often consists of establishing a system for measuring and monitoring indicators gathered each year from the companies in their portfolio. These indicators are standardised in order to facilitate dialogue and comparison between the practices of each company. These indicators provide valuable information with which to understand how a company interacts with its stakeholders. However, without a theoretical framework in which to contextualise them, these indicators describe only a small part of the story and are limited to describing the outcomes and effects of an investment.

In addition to being incomplete, the 'story' told by gathering indicators of impact proves to be a biased one. The multiple stakeholders that may interact with a project (clients, staff, suppliers, competitors, etc.) and the multiple dimensions (economic, social, cultural, etc.) means a choice has to be made with regard to the aspects you want to measure. These choices are made through a tradeoff between the relevance and availability of information. This often means limiting oneself to certain aspects of the impact and thus concealing part of the information; we measure above all that which is easy to measure, and not necessarily that which is most relevant.

The absence of an objective theoretical framework may create another bias insofar as the investor, who is also the evaluator, may tend to assess the positive impacts of his project to the detriment of the negative impacts, which are perhaps more difficult to ascertain. For example, knowing how many staff are employed by the target company's competitors, and any changes in this number, is crucial information but very difficult to obtain; depending on the maturity of the market and the level of competition between companies, an investment may very well end up creating jobs in the target company at the cost of destroying them among its competitors. The final impact in terms of job creation may thus prove negative even though the indicators demonstrate the contrary.

Without a clear and objective framework for analysis, one therefore runs the risk of seeing only what one wants to see and of validating implicit assumptions of impact, seen only as positive. This observation thus calls not only for the

use of independent evaluators with responsibility for monitoring the objective nature of the information provided, but also for more global evaluation work to be undertaken, taking into account a larger number of parameters and a wider timeframe for analysis.

5.2. What is the role of an impact evaluation?

The role of an impact evaluation is to measure the project's effects and identify what can be directly attributed to it. Once the effects have been evaluated, they need to be compared with what would have happened had the project not taken place. This situation, known as the 'counterfactual scenario', is what enables the project's role to be isolated from the many other causes likely to influence the noted situation; however, this comparison requires robust, costly and scientifically sound methods.

These methods – such as 'randomisation', to name but the most well-known – have the advantage of being highly sophisticated and are said to be 'attributive' as they enable the effect measured to be attributed to the project; they would merit being applied to impact investment. But they all have the common feature of being costly in terms of both time and resources, and of not being adapted to the context of the investor, who wishes to regularly measure the impacts of his companies. Other so-called 'contributive' methods do exist, however, and seem more in line with investors' expectations.

These analyses consist of building a theoretical framework with which to present the causal links between the project financed and the expected impacts. For example, if you are interested in job creation, you need to assume that the investment is not destroying jobs among your competitors (by assuming that the market is in full growth, for example) and that the people hired would have had great difficulty in finding a job of similar quality other than with the company. Indicators are thus established in order to validate or refute the hypotheses underpinning your analytical framework.

Strictly speaking, without a counterfactual scenario you cannot isolate the project's effect using these methods and thus cannot calculate its impact. These methods do, however, enable you to evaluate the way, although not the extent to which, the project contributes to what you have measured. At the heart of this approach is the fact that the assumptions on which the analytical framework are based need to be discussed, debated and, where appropriate, refuted in order to identify best investment practices. Because they illustrate the impact pathway, they are as necessary as the indicators.

Conducted in the context of particular work, and within the reach of the investors themselves, these methods are nonetheless very little known among impact investors. This is most probably due to the poor economic culture of a sector that has been built by operational actors from the finance sector, but also due to cost constraints. These evaluations are, in fact, laborious and involve additional work to the usual 'reporting' of investment targets. Given the limited size of their targets generally, cumbersome management costs have made impact investors reluctant to accept the costs for these evaluations. Identifying sources

of funding and collaborating with academic teams are two priority directions in which the sector needs to go in order to be able to produce convincing long-term 'stories'.

6. What future?

The extent of the constraints facing impact investment inevitably lead one to question whether it has a quantitatively significant future.

6.1. Encouraging outlook in terms of supply and demand

The answer needs to be seen in terms of the economies of supply and demand over the decades to come. It is clearly difficult to give a response in purely quantitative terms, although it is highly likely that this class of assets will continue to experience significant growth in the coming years.

On the demand side, in the developing world, the extent of needs within the SME and basic services sectors suggests the likelihood of extremely high demand for many years to come. In fact, the depth of demand for impact investors is linked to the likely continuation, and even worsening, of public and/or private failings. In terms of public failings, it is fair to say that demographic growth and the institutional fragility of states is likely to continue to create significant demand for private societal investment in basic goods and services, such as health, education, energy, water and sanitation. In terms of private failings, the weak financial systems in developing countries are likely to continue to make the financing of start-ups and SMEs through the market very difficult for years to come.

In terms of supply, the funding outlook appears to be a positive one. For private investors, 'donor fatigue' in relation to NGOs and the attraction of 'common sense financing' are now powerful trends. Impact investment has the advantage of offering yields that may be acceptable from the sole point of view of asset preservation, while giving an undeniable sense of purpose. It is undoubtedly one reason why the supply of capital coming from this kind of stakeholder will continue to grow consistently. Large multinationals will, for their part, become an engine for this kind of investment given that, as already noted, they see in it an original way of intervening in issues of strategic interest to them. Moreover, the segment is becoming increasingly attractive to public actors. Institutions providing public sector funding of the private sector are increasingly going to find their historic legitimacy questioned, and so will see in impact investment an ever-greater opportunity to increase their development impact. The donor states, for their part, are likely to see it as a way of improving the effectiveness of ODA at a limited, even zero, budgetary cost.

6.2. A number of obstacles remain

A lack of awareness of impact investment and its lack of visibility remain major obstacles. A definition that is still unclear creates significant confusion in relation to SRIs or philanthropy. The efforts being made by professional institutions to standardise and communicate the concept, as advocated by the G8 report, are much needed in this regard.

Moreover, impact investment remains a very new idea and it is coming up against a lack of confidence among investors; they want to see a history of established success that will guarantee the credibility of the approach in relation to the new funding challenges.

Impact investment represents a real innovation in the way an investment is valued, taking into account externalities that are not captured in its financial performance. This approach requires measuring and evaluation skills that still need to be developed. The emergence of this sector remains restricted for the moment by its human capacity, although this will gradually be mobilised and will draw on analytical methods that take both the financial and the social approach into account. The sector's legislative and regulatory framework also needs to be adapted. In fact, legal and regulatory mechanisms remain generally unfavourable to the development of this industry, which is caught between the hammer of mechanisms reserved for philanthropy and the anvil of those intended for lucrative investments.

7. Development partners, moving towards a future partnership for the sustainable development of the post-2015 agenda

Global public interest causes are likely to increase both in intensity and diversity in the 30 years covered by the 'post-2015' agenda.

Global population increase, conflicts over food, the environment and security, as well as migration and urbanisation, will all create a number of unprecedented challenges. In this context, all kinds of collective and socially responsible interventions will be needed to address the problems, and a global partnership linking all actors – both private and public, for-profit and not-for-profit – will need to be established to ensure their alignment.

Impact investment occupies a particular place on this agenda; not only because of the objective contribution it can make to resolving concrete problems, but also because of the link it creates between private and public actors. In the vast majority of cases, it brings different kinds of actor into closer contact within the same structures – for-profit or not-for-profit, public or private – and thus offers a 'cultural' meeting place that enables greater understanding between them and real, operational and concrete associations to be formed.

The challenges facing its roll-out are thus political and cultural, as well as strictly economic and developmental. Hopes for growth in this market, and the expansion of its contribution to meeting the challenges of globalisation and development, are very high. It will, however, only be effective if the regulators and public authorities encourage its growth and if impact investors themselves

improve their impact-measuring skills, build their capacity, and are able to demonstrate the effectiveness of their contribution on the ground.

If all this can be achieved then it is highly likely that the nascent category of impact investment will, over the coming decade, form a class of highly significant assets able to play a major role in development aid and in the management of global public goods.

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PART FOUR

FINANCING ENVIRONMENTAL SUSTAINABILITY

21

Country Allocations versus Issue Allocations: The Case of Climate Finance

Inge Kaul, Donald Blondin and Neva Nahtigal[1]

Introduction

Warning calls are alerting us in ever-more urgent terms that the world is at risk of not staying within the 2°C limit of global warming. This begs the question of why we are not addressing climate-related challenges in a more resolute manner.

There can be no doubt that additional resources will be needed for climate change mitigation and adaptation (CCMA), but speeding up progress will also require the efficient allocation of available funds. Consequently, this chapter focuses on the role and allocation of international public climate finance (IPCF). More specifically, it addresses the questions of whether IPCF is being used strategically to incentivise and complement state and private actor contributions, and whether its allocation is based on functional, goal-oriented criteria.

These questions arise because the CCMA goal, especially its mitigation component, has the characteristics of a global public good (GPG): if achieved, everyone will experience its effects. Therefore, like all other public goods, CCMA is at risk of free-riding and underprovision. This means that state and non-state actors may be willing to act on climate change only to the extent that doing so provides them with clear co-benefits, such as cleaner air in their respective cities. Thus, they are likely to neglect other corrective steps required for the desired good to emerge.

So, are IPCF resources being allocated in a strategic manner? That is, does the allocation process account for the special risk of dual – market *and* state – actor failure that plagues GPGs? Moreover, is the process *issue*-driven, i.e. focused on what needs to be done collectively at the national and international levels to prevent global warming from significantly exceeding the 2°C limit? Or, does the process remain essentially *country*-driven, i.e. centred on co-financing CCMA-related interventions that reflect national but not necessarily top global priorities? To answer these questions and address the related one of how IPCF could be used to accelerate progress, this chapter proceeds in the following manner.

1 The authors wish to thank Luis Gomez-Echeverri, Adolf Kloke-Lesch, Manfred Konukiewitz and Imme Scholz for comments and observations on earlier versions of this chapter.

Section 1 establishes four conditions for strategically oriented IPCF allocation: (i) recognition of the differences and synergies between the provisioning of global public goods and development assistance; (ii) preparation of a CCMA provision path map as a tool for identifying key policy outputs and targets at risk of underprovision; (iii) an adequately equipped IPCF toolbox; and (iv) a multi-tier allocation of IPCF resources based on functional, goal- and output-oriented criteria. Section 2 then assembles and analyses current IPCF allocation policies and practices. The main finding is that, at present, none of the aforementioned conditions is being fully met.

An important reason seems to be that public policy-makers in both the North and the South are still approaching global challenges in a conventional way, i.e. by focusing on their immediate national self-interests. In fact, grabbing a piece of the climate finance 'cake' is often seen as *the* benefit to vie for, as opposed to realising the ultimate goal of CCMA and reaping the – perhaps much larger and more sustainable – global public benefits it would afford. Accordingly, allocative choices associated with IPCF resources are marked by tension between 'giving something to all countries' and 'getting to the CCMA goal in a cost-effective and expeditious manner'. The strong contemporary reliance on using foreign aid for climate finance purposes reinforces this tension.

The conclusion that emerges from this discussion is that we urgently need to amend the institutional framework of climate finance by establishing a CCMA anchor agency charged with orchestrating a goal-oriented, time conscious/efficient and fair process of providing this GPG. This, of course, should involve broad consultation and cooperation, including with the Green Climate Fund (GCF). And, before they agree to embark on such a change in course, states will require proof that interventions designed to channel CCMA funds to where they can be most cost-effectively used are actually in their self-interest.

In more detail, the argument is as follows.

1. Allocating international public climate finance strategically

This section identifies conditions for a systematic allocation of CCMA-related IPCF, as defined in Box 21.1. These conditions take into account the nature of the overall goal and its components, as well as a key lesson learned from past experience: that effective international cooperation needs to be mutually beneficial.

Box 21.1 *Climate finance definitions*

Studies on climate finance usually stress that there is no agreed definition of climate finance or its various sub-aspects. In this chapter, climate finance-related terms are used as follows:

Total climate finance (CF)
All financial flows whose expected effect is to reduce net greenhouse gas (GHG) emissions and/or enhance resilience to the impacts of climate variability and the projected climate change. This covers private and public funds, domestic and international flows, and expenditures for mitigation and adaptation to current climate variability as well as future climate change.

International climate finance (ICF)
Climate finance that is channelled outside of the country in which it is sourced or that is sourced internationally.

International public climate finance (IPCF)
Funding provided by governments and other public sector entities, including multilateral institutions, for climate-related international cooperation purposes.

Bilateral IPCF flows from state to state. It may include, among other types like non-concessional flows, bilateral official development assistance (ODA) from OECD/DAC countries and South-South solidarity flows.

Pooled IPCF (PIPCF) refers to IPCF flows that are intended to co-finance an international climate-related endeavour. It can, for example, comprise finance from national environment or energy ministries, as well as multilateral ODA and other international assistance flows.

Source: Authors, except for the definition of total climate finance, which is taken from the IPCC (2014b). More detailed definitions of ODA can be found at www.oecd.org/dac/.

Condition 1: Recognition of the differences and synergies between development assistance and the provision of global public goods

The growing importance of transnational – and frequently global – policy challenges has had important implications for the translation of international agreements into actual policy change. Conventionally, the main concern has been development cooperation and the delivery of humanitarian assistance, especially in the wake of disasters in poorer countries. Yet, more and more policy challenges, including CCMA and its building blocks, are global public goods

that affect many (if not all) countries, both the rich and the poor, and, quite possibly, not only current but also future generations.[2]

As Table 21.1 shows, international cooperation in support of GPGs differs in important respects from development cooperation. GPG provision focuses on global challenges, and it is likely motivated primarily by agents' self-interest. Sometimes, though, and especially on the part of civil society actors, concerns about the future, the integrity of Earth systems and intergenerational equity also matter for GPG provision.

However, these fairness considerations should not be conflated with those that motivate development cooperation. Instead, they should be viewed as supplementary. In GPG provisioning, states meet as legal equals with different preferences and priorities, partially due to their different levels of development. Moreover, some actors may have contributed more than others to the emergence of a particular global challenge. Recognition of these facts underpins the principle of common but differentiated responsibilities and respective capabilities (CBDRRC)[3] as well as the concept of incremental costs.[4]

2 Public goods are defined here as goods that are non-rivalrous in consumption, non-excludable, or both. Depending on the geographic span of their benefits, costs or both, the goods are referred to as local (sub-national), national, regional or global public goods (GPGs), with the last category being of particular interest in the context of this chapter. Note that (i) the term 'good' has no value connotation – it is short form for goods, services and conditions that possess the properties of publicness; (ii) the term 'global' does not refer to the international level of policy-making but to the world-spanning transnational nature of the good; and (iii) like any type of public good, GPGs can be of a final type (i.e. the good that we actually desire to consume or are currently consuming, for better or worse) or of an intermediate type (i.e. a good that feeds, possibly together with other elements, including private goods in some cases, into the final GPG). For a more detailed discussion on public goods and GPGs in particular, see, among others, Kaul *et al*. (2003) and Sandler (2004).

3 For a detailed discussion of this concept and its historical evolution, see, among others, Brunnée and Streck (2013).

4 In Article 4.3 of the UNFCCC of 1992, the developed country parties agreed to cover 'the full incremental costs' of agreed mitigation measures implemented by developing country parties. They also agreed to 'assist the developing country parties that are particularly vulnerable to the adverse effects of climate change in meeting costs of adaptation' (Art. 4.4) and to cover the agreed full costs incurred by developing countries in the preparation of their national communications (Art. 4.3). The term 'incremental costs' thus refers to these three types of additional costs that developing countries may incur (see http://unfccc.int/resource/docs/convkp/conveng.pdf/).

Table 21.1. *Differences and synergies between development assistance and GPG provision*

Dimension	International cooperation in support of the development of present generations	International cooperation in support of GPG provision in the near or medium term	International cooperation in support of the GPG 'global longer-term sustainability'
Main rationale	Concern about 'others'/equity	Self-interest (e.g. territorial, national, personal, electoral, depending on the stakeholder); efficiency	Enlightened self-interest; respect for inter-generational equity and global systemic integrity
Focus/ framing of the intervention	National development, notably poverty reduction in poor countries	A global issue and/or the structure and composition of the global public domain	The future (related to a global issue) brought into current decision-making
Cooperating parties	Rich and poor countries, their respective cooperation partners and stakeholders	Interested demand-side parties and potential suppliers (across actor groups), whose interest in the issue may or may not overlap	The parties involved in issue at stake (broader in the case of GPGs than in the case of development)
Nature of the interaction	Transfer of financial and non-financial resources, including policy advice/ conditionality, mainly at the country level	Issue identification and contextualisation; agreement on the policy outcomes to be generated in a decentralised or pooled way; trade in the inputs of global public goods (e.g. certified CO2 emission reductions)	Agreement on whether and how to share the costs of fostering inter-generational equity and global systemic integrity; monitoring and enforcement
Main intended beneficiaries	Poor countries and poor people	One's self, including (depending on one's identities and interests) a world filled with such GPGs as relative peace and security or conditions of human decency and non-discrimination	Future generations and the Earth as a whole
Determinants of an effective intervention	An adequate and development-compatible provisioning of GPGs, lest one hand (GPGs such as the international trade regime or financial architecture) take away what the other hand (e.g. development assistance) tries to give	The domestic and international capacity of all concerned states to cooperate in a result-oriented manner, including effective national development; minimising free-riding	Efficient and effective GPG provisioning at present; research, development and awareness-raising in order to enable current and future generations to take longer-term concerns into account

Source: Authors.

Accordingly, a well-targeted and incentive-compatible approach to CCMA would need to recognise these differences, as well as possible synergies, between development cooperation and GPG provision. This is especially important at a time when multi-polarity and demand for more participatory, transparent and accountable policy-making are growing. Under these conditions, the effectiveness of international cooperation depends on its being perceived as offering all concerned parties a fair, mutually beneficial deal. This is also why the goals of mitigation, adaption and SE4ALL ought to be promoted together.[5]

In addition, just as development depends on an adequate provision of GPGs, effective GPG provision will, in many cases, not be possible without effective development. To benefit from the consequent synergies, each strand of cooperation should be promoted in line with its underpinning rationales and governance requirements.

Indications of a differentiation between the development cooperation and GPG branches of IPCF would be:

- the non-use of development cooperation funds, including official development assistance (ODA), for CCMA-related purposes;
- CCMA-oriented IPCF contributions clearly comprising new and additional resources (notably in relation to ODA), as stipulated in various international agreements;
- CCMA-related IPCF allocations being reported – according to well-defined rules and procedures – by the countries of origin to a central tracking agency for GPG financing (that does for GPG finance what OECD/DAC does for ODA).

Condition 2: Identification of potential IPCF roles based on CCMA provision path analyses

The CCMA goal calls for actions to be taken worldwide, by state and non-state actors, so this will be a highly complex undertaking. Moreover, due to the GPG properties of the goal and its components, collective-action problems must be expected, and they will be exacerbated by the ongoing scientific, technological and political uncertainties.

Therefore, it would be useful to prepare at least a rough sketch of how the overarching goal of CCMA could be met. The main purpose of such a provision path analysis would be to establish (i) the types and scale of inputs that will be required; (ii) their appropriate providers; and (iii) the recipients of any potential transfer payments.

5 SE4ALL refers to the Sustainable Energy for All initiative launched by UN Secretary-General Ban Ki-moon in September 2011. It is a multi-stakeholder, multi-actor partnership that aims at improving energy efficiency, increasing the share of renewable energy in the global energy mix and, of special importance in the present context, ensuring universal access to modern energy services. Thus, SE4ALL serves a dual purpose: it is an indispensable ingredient of effective development; and it strengthens the built-in equity of the global climate regime (for more details, see http://www.se4all.org).

With this initial map, a survey of ongoing policy interventions could be made to determine if they are generating the requisite inputs for the overall GPG. In case of shortfalls or distortions, one could explore whether an international public policy intervention is warranted, and if so, whether it would require IPCF resources, notably pooled IPCF (PIPCF).

Besides identifying provision problems, a provision path analysis would also provide an integrated perspective on how 'bottom-up' and 'top-down' contributions complement each other. Importantly, this approach could take into account the fact that some global challenges, such as CCMA, require interventions beyond what individual actor groups, or even all actor groups together, are willing to contribute if guided only by their immediate self-interest. Hence, additional international-level interventions could be needed. These could be designed to strengthen actors' willingness to cooperate and make extra efforts in order to enhance global sustainability. Or, they could be aimed at the provisioning of intermediate GPGs such as global weather watches or technology banks. In both respects, IPCF could play an important role.

Evidence of an attempt to identify potential roles for IPCF through a provision path analysis would include:

- availability of CCMA-related provision path maps;
- identification of provision shortfalls and distortions based on comparisons between these maps and the findings of monitoring and assessment reports, as well as national submissions on planned activity programmes that might already be prepared; and
- specification of corrective actions that would benefit from IPCF and, especially, PIPCF support.

Condition 3: An adequately equipped IPCF toolbox

In order for money, including IPCF, to effectively serve the intended public policy purposes, it has to be available in the right form, at the right time, and in the right amount (Kaul and Conceição, 2006).

Leaving aside the 'right amount' aspect,[6] an adequate IPCF toolbox would include instruments that allow multilateral development banks (MDBs) to leverage more private finance and thereby increase the availability of low-cost capital for poorer developing countries (on this point, also see IPCC, 2014b and Kato *et al.*, 2014). Other important tools include methods for calculating incremental costs, which would incentivise developing countries that have the opportunity, capacity and means to do so to go beyond shifting their own economies onto a low-carbon growth path; for example, by offering other nations, private actors or the international community the option to achieve additional CO_2 reductions. In other cases, IPCF could support national-level capacity building for purposes related to CCMA and SE4ALL.

6 The quantitative and qualitative aspects are, of course, closely intertwined. If resources are scarce, certain tools may be neglected altogether or only be used in a crudely designed and ineffective manner.

Furthermore, IPCF resources could act as subsidies or prize money to encourage critically needed research and development (R&D), and they could sometimes take the form of advanced purchase or market commitments.[7] Or, they could help share the costs of international-level GPG-type facilities, such as low-carbon technology banks, knowledge platforms or insurance and other risk management schemes. These usages, in particular, would call for PIPCF.

Indications of the tailored use of IPCF to help meet established global public policy purposes inadequately addressed by other funding streams could be found in:

- descriptions of the mandates of CCMA-related international financing and delivery mechanisms; and
- reports that track climate finance.

Condition 4: Functional criteria for the allocation of pooled IPCF resources

IPCF comes in bilateral and multilateral – i.e. pooled (PIPCF) – forms. The share of each form in terms of total IPCF depends, among other things, on: i) states' international commitments; and ii) the indications of high-return investment possibilities. If provision path analyses demonstrated that greater reliance on the non-rival benefits of intermediate GPGs could best meet national and global concerns, then the share of PIPCF might rise. If, in addition, PIPCF were used in a catalytic way – for example, to demonstrate the feasibility and desirability of multilateral, collective-action endeavours – this might attract additional IPCF resources to such purposes and thereby contribute to lowering the overall costs of CCMA. Otherwise, bilateral flows would perhaps dominate, being pulled and pushed according to the national priorities of their country of origin and/or destination.

So, on the operational side of CCMA-related international cooperation, resource allocation issues arise especially in respect to PIPCF – the multilateral form of IPCF.

Table 21.2 outlines a three-tier process that a strategic, goal-oriented allocation of PIPCF resources could follow. Efficiency considerations, as well as the established global principles and commitments related to CCMA, are taken into account.

These include the principle of common but differentiated responsibilities and respective capacities (CBDRRC) and the developed countries' commitment to pay the full incremental costs of the agreed mitigation and adaptation measures of developing countries. After all, fairness, too, has to be produced.

7 Advance purchase or market commitments are promises by a buyer or group of buyers to purchase a good at a certain amount and price when it is available.

Table 21.2. *A framework for allocating climate-related pooled international public finance (PIPCF)*

Tier	Primary allocation to:	Secondary allocation to:
1.0	**Overall goal** (e.g. CCMA)	
2.0	**Sub-goals** (e.g. mitigation, adaptation, SE4ALL)	
3.0	**Outputs** (depending on sub-goal provision path)	
3.1	**International financing mechanisms for:**	
	3.1.1 **Mitigation-related purposes such as**:	
	• Lowering the cost of capital, improving access to capital, risk reduction, etc.	Developing countries that could generate high-impact results
	• National capacity building	Same as above
	• Monitoring, review and verification obligations	Same as above
	• Incremental cost re-imbursement (e.g. for CO_2 reductions beyond expected/ voluntary national commitments)	Same as above
	• R&D incentives	Best-suited providers, be they states or non-state actors
	3.1.2 **Adaptation-related purposes such as**:	
	• Incremental cost reimbursements for country-/ location-specific adaptation measures	Poor and highly vulnerable developing countries
	• Compensation for loss and damage (eventually to be paid in the future)	Same as above
	3.1.3 **SE4ALL-related purposes such as**:	
	• Those mentioned under 3.1.1	Developing countries with a large number of energy-poor households
	• Building links to relevant aid projects	Same as above
3.2	**International direct-provision mechanisms** generating intermediate GPGs (related to sub-goals 1-3) such as:	
	• Knowledge platforms	
	• R&D on relevant 'hard' and 'soft' technologies, the results of which will be in the global public domain	
	• Global low-carbon technology bank	
	• Subsidies for affordable natural disaster insurance	
	• Global meteorological services	

Source: Authors.

Evidence of a functional approach to resource allocation could be found in:

- operational guidelines and business plans of various funding mechanisms in the climate field; and
- annual reports of international funds and agencies with climate-related activities.

Before moving on to actual policy practice, it should be emphasised that the four conditions for a strategically oriented allocation process are closely interlinked. That is to say, Condition 4 could not be met without also meeting Conditions 1, 2 and 3.

2. Assessing the current pattern of climate-related IPCF allocations

Even a cursory look at present-day climate finance suggests that none of the aforementioned conditions for a strategic IPCF allocation is being fully met. To illustrate:

2.1. Development assistance and GPG provision are not being differentiated

Precisely the opposite of differentiation between development assistance and GPG provision is happening. Bilateral and multilateral aid agencies appear keen to demonstrate that they devote a considerable part of their funds to climate-proofing development. As Box 21.2 shows, on average, some 16% of total bilateral ODA, or US$21.5 billion annually, was climate-related during the years 2010-12. Moreover, climate-related spending by MDBs amounts to US$27.9-30.4 billion. Thus, climate finance siphons off a large amount of development assistance.

The confounding of aid and GPG financing is not happening inadvertently. In fact, parts of the aid community argue for the intertwining of development and CCMA concerns.[8] Of course, these efforts are mutually supportive and can reinforce each other at the country level. However, this is no reason for not providing new and additional resources for interventions that specifically target mitigation or adaptation objectives, as stipulated in numerous international agreements.

The lack of a clear definition of GPG finance and the non-existence of accounting and reporting procedures adds to the confounding of aid and GPG provision.[9]

8 See, for example, OECD/DAC (2014), notably Chapter 18, and Mitchell and Maxwell (2010).

9 On this point, also see Clapp (2012), Falconer and Stadelmann (2014) and IPCC (2014b). The lack of clear definitions and clear reporting procedures is being noted again and again, even in official documents. Yet, no corrective action is in sight. Regarding the arbitrariness of the reporting on Fast-Track-Finance, see, for example, UNFCCC (2013).

Box 21.2. *Estimates of climate finance flows*

Quantitative data on climate finance flows are limited, and often not comparable as there is no agreed-upon set of definitions. Therefore, the following figures are mostly estimates. Moreover, they mainly refer to commitments rather than disbursements. The pattern of climate finance flows emerging from the available estimates of annual average allocations during the years 2010/11/12 is as follows:

Total climate finance (CF): US$359 billion*

Private CF: US$224 billion, or 62% of total CF

Public CF: US$135 billion, or 38% of total CF

CF allocations to mitigation: 95%

CF allocations to adaptation: 5%

Nationally sourced CF: US$273 billion, or 76% of total CF

Internationally allocated CF: US$86 billion, or 24% of total CF

CF flowing from North to South: US$39-62 billion**

International Public CF (IPCF): US$35-49 billion

- **Bilateral ODA**: US$21.5 billion, representing 16% of total ODA in 2010-12, of which 58%, 25% and 18% are flowing to mitigation, adaptation, and activities addressing both, respectively.
- **Multilateral ODA**: US$3.8 billion, representing 2.7% of total ODA
- **Funds allocated by MDBs**: US$24.1-26.6 billion
- **Pooled international public climate finance (PIPCF)**:*** ≈ US$27.9-30.4 billion, representing about 8% of total CF

Notes: *This is the figure presented by Buchner *et al*. (2013). It covers total – not incremental – investments and framework expenditures. The estimate of IPCC total flows is based on a similar definition and given as US$343-385 billion. The Buchner *et al*. figure of total flows is used to estimate the share of the sub-flows of total climate finance. **Little is known about South-originating and South-South climate flows, and therefore no figures for these flows are presented here. ***Includes multilateral ODA, which is comprised of climate-related allocations to international climate funds, multilateral organisations and MDBs.

Source: Buchner *et al.* (2013), IPCC (2014b, Chapter 16), OECD (2013) and March 2014 version 3 of www.oecd.org/dac/stats/rioconventions.htm/.

2.2. *A crowded operational field without a map or a clearly defined role for IPCF*

There is no indication that CCMA provision path analyses are being prepared, though it would be feasible to do so. For example, a comprehensive policy framework is outlined in Stern (2007). This could be complemented and updated with insights from journal articles, IPCC reports and international agencies, including the International Energy Agency (IEA), the International Renewable Energy Agency (IRENA), the Renewable Energy Policy Network for the 21st Century (REN21), the United Nations Environment Programme (UNEP), the

UNFCCC Secretariat, the World Bank, the World Meteorological Organization (WMO) and many others.

In the absence of provision path analyses, a large number of actors are intervening in the climate field without the benefit of the sense of direction and balance that such analyses could provide. For example, the UNDP/World Bank website on Climate Finance Options lists some 130 international funds dedicated to climate change issues,[10] which, as the UNDP (2012, p. 6) points out, operate alongside 60 carbon markets and more than 6,000 private equity funds.[11] Add the long list of operational initiatives that the Ad Hoc Working Group on the Durban Platform for Enhanced Action has identified (UNFCCC, 2014), and it becomes clear why analysts characterise the current institutional landscape of climate finance as crowded, fragmented and opaque.

This impression also stems from the fact that landscape sketches are commonly drawn *ex post*, once funds have been committed or disbursed to the myriad implementers, making it virtually impossible to establish reliable flow estimates. Therefore, as can be seen in Box 21.2, carbon finance flows are often merely estimated. For example, IPCF is indicated as ranging between US$35 and US$49 billion per year.

Despite this opaqueness, the figures in Box 21.2 clearly show the following:

- Most climate finance does not flow to international destinations, but is used in the country in which it is sourced.
- Mitigation receives 95% of total climate finance, leaving a mere 5% for adaptation.
- Climate-focused bilateral ODA also has a 'mitigation bias' and siphons off funds from ODA's goal of national development in poor countries. Out of the total annual amount of US$21.5 billion, mitigation receives 58%, adaptation 25% and 18% flows to initiatives that address both mitigation and adaptation.
- PIPCF appears to be relatively limited, amounting to about US$3.8 billion.[12]

As with the non-differentiation of aid and GPG provisioning discussed earlier, the current free-for-all approach to addressing climate change issues has not developed accidentally. It has strong advocates, including Nobel Laureate Elinor Ostrom, who was one of the most ardent proponents of a polycentric approach, even in global policy areas.[13] Many in the academic and international policy communities take a similar position.

Certainly, polycentricity encourages context specificity, experimentation and innovation. However, without an overall framework, policy interventions may

10 See http://climatefinanceoptions.org/.

11 For more detailed analyses of the fragmented institutional landscape of climate finance, see Gomez-Echeverri (2013), Nakhooda *et al.* (2013), Boyle *et al.* (2014), IPCC (2014a, Chapter 13) and Van Asselt and Zelli (2014).

12 For possible reasons leading to the mitigation bias of climate finance, see Abadie *et al.* (2013).

13 See Ostrom (2009), as well as Edenhofer *et al.* (2013) and IPCC (2014a).

go astray and stay disconnected, problems of duplication may occur, and some actors – especially private finance – may just follow 'a path of least resistance', as Boyle *et al*. (2014, p.10) have shown.

Due to the absence of provision path analyses, CCMA-related activities are being undertaken without a clear idea of the various ways in which IPCF, and especially PIPCF, could accelerate progress. The only role of IPCF that is extensively discussed is that of mobilising more private climate finance.

2.3. The leveraging of private finance as the main role of IPCF

Discussions on the scaling-up of climate finance appear to rest on a pair of tacit assumptions: i) that what is first and foremost needed is the mobilisation of more private finance; and ii) that public finance has a key role to play – nationally and internationally – in enhancing the market competitiveness of CCMA-related projects.[14] This is a critical role for IPCF considering the large gap between the actual level of climate finance and identified needs.[15] But, its other potential roles (discussed in Section 1) are also important, particularly the promotion of fair and mutually beneficial cooperation outcomes and the realisation of efficiency gains through provisioning of non-rival intermediate GPGs, both of which would strengthen countries' willingness to contribute.

Also worth highlighting is that throughout the climate finance literature, sparse mention is made of incremental costs and their calculation at the project level. Are grants and soft loans (to which some developing countries might be entitled) intended to be reimbursements of incremental costs? Of course, the mandate of the Global Environment Facility (GEF) is to meet 'agreed incremental costs to achieve agreed environmental benefits' (GEF, 2011, p.12). However, it is not clear whether or how other climate funds apply this concept, how these costs are calculated, or how strong their incentive effect is. Basically, not much is known about the extent to which developing countries' immediate climate-related investment requirements are being reimbursed. It is also not clear how the longer-term incremental costs will be reimbursed – nor which reimbursements may constitute 'new and additional' money (see also Olbrisch *et al*., 2011; Stadelmann *et al*., 2011).

2.4. National interests compete with functional considerations in resource allocation

From the major policy documents on climate change, as well as from the mandates of funding mechanisms, it is evident that states are aware of the necessity of a step-change in responding to the CCMA challenge. However, policy-makers still seem to find it hard to accept – even if acceptance would be in their self-interest – that we are living in an interdependent world, especially when it comes to global warming.

14 For an informative overview of ongoing activities and related literature, see, for example, Kato *et al*. (2014).

15 For various estimates, see Buchner *et al*. (2013, p. 33)

As a result, a number of international mechanisms seem to be using resource allocation formulas that seek to combine global and national concerns. For example, the GEF aims to ensure the 'cost-effectiveness of its activities in addressing the targeted global environmental issues [while funding] programs and projects which are country-driven and based on national priorities' (GEF, 2011, p. 12). Moreover, the GEF applies allocation floors 'to balance the need for every country to receive a sizeable allocation with opportunities to generate maximum global environmental benefits' (GEF, 2009, p.7). The UNFCCC Adaptation Fund even applies uniform caps on resources that eligible countries can receive.[16]

The Green Climate Fund has decided to set similar aims for its initial resource allocations: (i) a 50:50 balance between mitigation and adaption over time; (ii) a floor of 50% of the adaptation allocation for particularly vulnerable countries; (iii) managing access to resources so that allocation is geographically balanced, reasonable and fair, while maximising the scale and transformational impact of the fund's activities; and (iv) maximising engagement with the private sector, including through a significant allocation to its Private Sector Facility.[17]

Thus, even though these financing mechanisms are expected to contribute to the attainment of a global goal through the distribution of PIPCF, they remain essentially country-focused and country-driven.[18] And the cited examples are not exceptions in this regard, as a GCF study of resource allocation models used by select global funds has shown (GCF, 2013).

Yet, some international financing mechanisms seem to be of the hybrid type – they are generating global public benefits through country-level work. Examples include the Clean Technology Fund, which is part of the Climate Investment Funds (CIFs), and the Climate Technology Centre and Network (CTCN). Through the financing of country-level initiatives, they also try to pilot and test new policy responses, analyse and disseminate the lessons they learn, and thereby help other actors to learn as well.[19]

Matters are also somewhat different in the case of the international direct-provision mechanisms such as the UNDP/World Bank Platform Climate Finance Options, the Climate Policy Initiative (CPI), Climate Fund Updates and REN21. These initiatives aim at connecting the many actor and intervention 'dots' of the climate finance landscape by sharing knowledge and experiences. In other words, they provide outputs of a public good nature. Mention could also be made of the valuable work done by UNEP, the United Nations Industrial Organization (UNIDO), various UNFCCC bodies, the World Meteorological Organization and, of course, the IPCC, along with international think tanks and civil society organisations; all are using PIPCF resources. Yet, current climate finance

16 See https://www.adaptation-fund.org/system/files/AFB.B.11.5.Initial%20Funding%20Priorities.final_.pdf.

17 See GCF (2014).

18 Interestingly, although a recent evaluation notes a certain lack of effectiveness and impact for GEF's activities, it does not consider whether GEF's resource allocation framework could be a reason for this finding (see GEF, 2014).

19 See, for example, https://www.climateinvestmentfunds.org/cif/.

tracking initiatives barely mention these contributions. But should they not be considered?

It seems that our policy approaches to global challenges like CCMA, as well as our current resource allocation procedures, are caught in two policy traps: i) the foreign aid trap, which leads to international cooperation activities being primarily country-driven rather than issue-driven;[20] and ii) the national interest trap, which leads, at least on the operational side, to the neglect of two sets of inputs required for the overall goal, namely, a) national-level reform steps that exceed immediate national interests, and b) the provision of international-level building blocks such as the creation of a global green and affordable technology bank.

Conclusion: Adding the missing links – an anchor agency for CCMA operational activities and proof that an issue-driven allocation of resources 'pays'

The foregoing analysis suggests that none of the four conditions for the strategic use of IPCF resources identified in Section 1 is being fully met. The reason seems to be that the policy approaches to the CCMA challenge, and with them the resource allocation procedures, are essentially driven by country or national interests rather than global issues or challenges. In the international realm, this policy pattern is reinforced by the heavy involvement of foreign aid in the delivery of IPCF.

Being driven by close to 200 nations, including 'donors' and 'recipients' with strong preferences for public-private partnering and a bottom-up summation of inputs, climate change mitigation and adaptation is a vibrant policy field with innumerable actors. It is also a highly fractured field. There is no agency or agent in charge of managing – in a light-footed and enabling manner – the provision path process. Yet, bearing in mind the warning calls from the IPCC and others, it is time to switch course. One way forward is a resource allocation framework that keeps actors' attention focused on the timely attainment of CCMA and its sub-goals, i.e. the building blocks that need to be produced first.

Put differently, IPCF and other resources would – for reasons of efficiency, equity and effectiveness – best be allocated according to functional issue- and result-oriented criteria. Where countries prove to be the best providers of intermediate-level goods, or where they qualify as recipients of incremental cost payments or other compensatory finance, they would, in subsequent allocation rounds, receive climate finance flows. Thus, a paradigm shift is required. While it is fitting for aid allocations to be made according to country-oriented criteria, resources for CCMA and other GPG-type issues would best be allocated according to issue-oriented criteria.

Initiating this shift requires someone to take the lead in the mutual interest of all, because global and national interests have to be combined such that all

20 Of course, in the case of foreign aid, which is intended to support a country's national development, the focus on projects and programmes being country-owned is fully justified.

countries and, ideally, all people are better off. Therefore, it would be desirable to establish a CCMA anchor agency that could initiate reform steps along the lines suggested in Section 1. Though it might be located within the UNFCCC, the anchor agency would perhaps function best as an independent, technical body, supported by a high-level technical advisor group and headed by a CEO with extensive, worldwide public and private sector management experience. How to shape the product of 'CCMA', i.e. which efficiency and fairness considerations to take into account, would of course remain the prerogative of the legislative bodies. The anchor agency's mandate would 'just' be to help the myriad actors achieve the goal and, to this end, advise on the roles that IPCF can play as a driver of the transformation process.

But why would states agree to switch from a largely country-driven approach to resource allocation to an issue-driven one?

One reason is time. Clearly, the country-driven approach is not working; certainly, it is not working quickly enough. And key actors are realising this. But, these facts must be supplemented by a sovereignty-compatible rationale for CCMA-related interventions. This will require well-framed, nationally and regionally disaggregated proof that it is in states' self-interest to channel money to where it can be used most cost-effectively to produce the intermediate-level GPGs required for CCMA. This would imply getting the balance right between climate-related national public finance and IPCF, as well as between bilateral and multilateral, i.e. pooled, IPCF.

So, why not use the forthcoming COP 21 in Paris to agree on the creation of a CCMA anchor agency that could help us to overcome some of the collective action barriers that are currently blocking a more strategic approach to the allocation of climate finance? In the meantime, we should compile evidence supporting the viability and necessity of the issue-driven approach, and we should draw up the draft terms of reference for the anchor agency so that consultations can be initiated.

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22

COP21: A Proposal for International Funding of Energy Transition in Emerging Countries[1]

Gaël Giraud, Alain Grandjean and Benoît Leguet

Introduction: The limitations of climate negotiations

The international context

International climate negotiations tend to stumble when it comes to matters of financing. G77 countries expect developed countries to adhere to their commitments, namely to mobilise US$100 billion a year to help them combat and adapt to climate change, with a significant share of these funds for climate change adaption being channelled through the Green Climate Fund, established at the Cancun Climate Change Conference (COP16) in 2010. Should this condition not be met, the Paris Conference (COP21) in 2015 would more than likely end in failure, with disastrous consequences for the climate and for the organising authority, the French government. Some consider that an important step would be to produce a more precise definition of the investments to be made and financed and the instruments needed to ensure that these funds are used appropriately. Whilst this groundwork is indeed essential, it will clearly not be sufficient in itself.

In reality, the amounts concerned are small: global oil exploration and production costs US$700 billion a year and fossil fuel subsidies US$500 billion. Europe will need to commit thousands of billions of euros in the coming decades to ensure its transition to low-carbon energy sources and lower energy consumption.

The challenges these countries face are obviously huge. Climate change is already a source of significant economic and social disruption. This can but grow and lead to higher numbers of victims and greater damage.

Yet if we go no further than the conventional line of thinking, these funds will not be forthcoming. In overall terms, Europe is stagnating. Budget cuts and austerity are the order of the day. Japan has not emerged from the difficulties it

1 This chapter benefited from the financial support of the Fondation pour les Etudes et Recherches sur le Développement International (Ferdi) and of the French government programme “Investissement d’Avenir” (reference ANR-10-LABX-14-01). The authors would like to thank Jaime de Melo for his suggestions.

has been facing for over 20 years. Recovery is under way in the United States but against a backdrop of extreme budget tension at the federal level. How can the citizens of these countries be persuaded, as of now, to make further efforts to support distant countries and step up the levels of development assistance?

On a broader note, it is important to point up two contradictions at the core of the negotiations.

On the one hand, climate change is now recognised as a major, universal danger; its causes have been clearly identified and, although its economic impacts are necessarily imprecise, they are also considered to be significant. More specifically, they have the potential to challenge the macroeconomic and financial stability of most countries across the planet.[2] And yet, the resources allocated to combating excessive climate change and adapting to the changes currently under way are far from adequate.

On the other hand, major global financial organisations such as the International Monetary Fund (IMF), which is nonetheless explicitly mandated to safeguard the world's macroeconomic and financial stability, are not party to these international negotiations. Combating and adapting to climate change, however, are not only key issues for protecting the growth potential of human activities, particularly in the G77 countries, but also the means to give fresh momentum to activities in developed countries – which need to innovate and find ways of developing sustainably – and thus an absolute prerequisite for the macroeconomic and financial stability of every country on the planet.

When the financial crisis hit the United States, and particularly after the collapse of Lehman Brothers (on 15 September 2008), the monetary authorities in the 'advanced' countries reacted quickly to avoid a new '1929 crisis'. They were able to make use of the IMF's power to create Special Drawing Rights (SDRs). The G20 Summit in April 2009 authorised the IMF to issue new SDRs worth US$250 billion to help the main 'advanced' economies to weather the liquidity crisis that was threatening their respective interbank markets. If the IMF is able to tackle a financial crisis using newly created reserve assets, could it not also address the challenge of financing climate change using the same process?[3]

This chapter suggests that the IMF's monetary mechanism could be used in the current context to reconcile the objectives of supporting economic activity and of moving it in the direction needed to respond to climate change. The financial and monetary authorities should ideally be present at COP21 in order to embody this major paradigm shift. Given the IMF's capacity to create new international reserve funds in the form of its own accounting unit, the SDR, it would seem to be the most appropriate international institution to provide some of the funds for energy transition, in line with the modalities underpinning this proposal. Of

2 See, for example, the report by the interdisciplinary research team funded by NASA (available at http://www.ara.cat/societat/handy-paper-for-submission-2_ARAFIL20140317_0003.pdf).

3 The authors of this chapter, and others with them, suggested very early on that the liquidity generated through non-conventional monetary policies involving quantitative easing could be channelled into green investments (e.g. Giraud, 2013).

course, a decision in favour of a financing tool of this kind is basically a political one – as was the launch of the Green Climate Fund itself. However, the decision-making will be all the easier if actionable and realistic funding proposals are put forward.

Current tools for combating climate change

Traditionally, there have been two approaches to combating climate change: adapting to climate change and reducing (mitigating) GHG emissions. It is often suggested that funding should be divided on a 50-50 basis between these two types of action. This split has arisen from negotiations within the Green Climate Fund. Whatever their final outcome, it nonetheless suggests two distinct but complementary types of funding.

GHG mitigation actions mainly involve developed and emerging countries. Some of these actions (e.g. renewable energy production and energy efficiency) are likely to generate revenue in the long term, admittedly at a low level but something nonetheless. They are therefore eligible for 'green loans' (see Section 2.1).

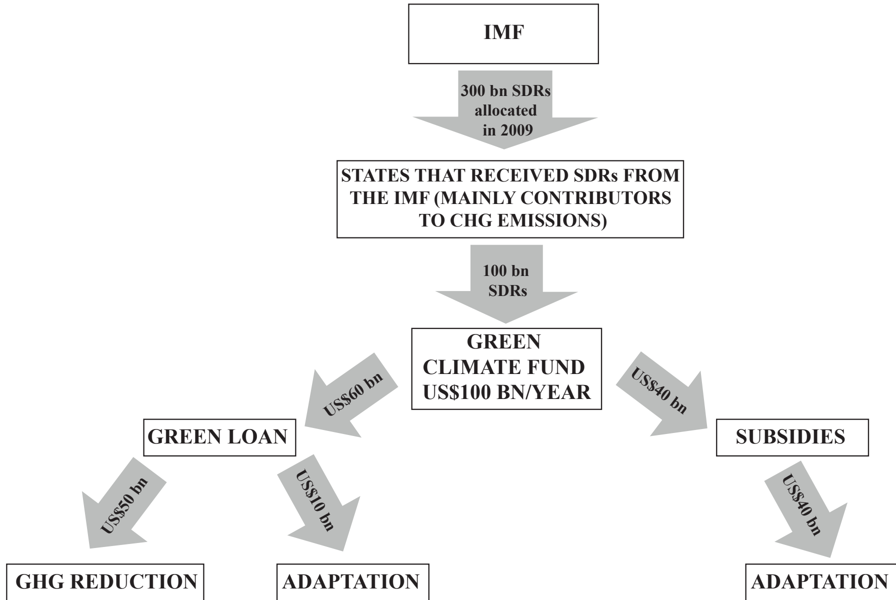
Adaptation actions primarily concern very low-income countries and are unlikely to generate much revenue. They should thus be funded mainly by subsidies (see Section 2.2).

1. An international financing tool

Since 2009, many contributions have fed into the debate on the best way of strengthening the role of SDRs within the international monetary system. The annual creation of reserve assets in the form of additional SDRs to fund the necessary reduction of climate change effects (and, more generally, implement the Millennium Development Goals) would, in the eyes of many analysts, represent significant progress towards reform of the international monetary system.

This proposal examines one version of this type of funding. It is inspired by these various contributions but departs from some of them on a number of points. Given that the objective is to transform the US$100 billion commitment referred to at Copenhagen into sustainable financial flows based on affordable solutions, funding would come primarily from the G21 and be funnelled through the Green Climate Fund to mobilise US$100 billion a year.

Figure 22.1. *Proposed scheme for an international financing tool for low-carbon or adaptation projects*



1.1. The Green Climate Fund

This proposal hinges on the idea of introducing a financing tool that uses the IMF's capacity to support a new international reserve currency in the form of SDRs. The intention is to provide support for financing tools, in particular the Green Climate Fund.

In this scheme, the Green Climate Fund is responsible for selecting projects that are eligible for SDR funding. In other words, the IMF has no right of oversight on how the money it makes available to countries is used. This is important for at least two reasons. First, at the World Economic Forum in Davos in 2010, when the then IMF managing director Dominique Strauss-Kahn presented the idea of financing a Green Climate Fund by issuing SDRs, the IMF Executive Board opposed it on the grounds that the IMF's mandate did not cover supervising investments related to energy transition. The Board's opposition was not, however, included in the IMF note (IMF, 2010) and does not therefore constitute an official position. Nonetheless, the reaction of the member countries – which, except for France and the United Kingdom, responded negatively to the proposal as it was formulated – needs to be taken into account. The IMF's involvement in the financing tool proposed here is therefore justified by the fact that climate change threatens to have a major impact in terms of macroeconomic and financial destabilisation, but this does not imply any kind of participation in the governance of the Fund. The second reason is that several emerging countries will likely be reluctant to receive conditional loans from the IMF

given the history of such loans and the fact that these have so often been tied to structural adjustment plans. It is for this second set of reasons that our proposal involves entrusting the governance of transition financing to the Green Climate Fund rather than to the IMF itself.

1.1.1. What about mitigation and adaptation?

To return to what was mentioned earlier, the combat against climate change is traditionally fought on two fronts: actions to mitigate GHGs and actions to adapt to climate change.

For illustrative purposes, the example below is based on an annual financing of US$100 billion by 2020 for investment in energy transition, as proposed at the Copenhagen summit. The tool outlined below can obviously be adapted to other annual funding arrangements. In 2010, the IMF (2010) estimated that an annual fund of US$100 billion could reasonably be split into US$40 billion of subsidies intended solely for adaptation projects and US$60 billion intended for GHG mitigation projects (accounting for five sixths of the US$60 billion) on the one hand, and for adaptation projects (one sixth of the US$60 billion) on the other. If 50% of the total budget is allocated to GHG mitigation, the 60/40 split between loans and subsidies results in adaptation funding comprising 80% in the form of subsidies and 20% in the form of loans, which seems reasonable. We will therefore use the same breakdown. For illustrative purposes, we will work on the basis of a ten-year time frame.

Our proposal is that some IMF member countries transfer to the Green Climate Fund all or some of the SDRs that they already have in hand following the August-September 2009 allocation. So far, and given that no SDRs have been sterilised since then, the number of SDRs available as exchange reserves held by national central banks is around 204 billion, or approximately US$309 billion at the 10 September 2013 exchange rate. The ‘advanced’ countries alone received US$176 billion in 2009.

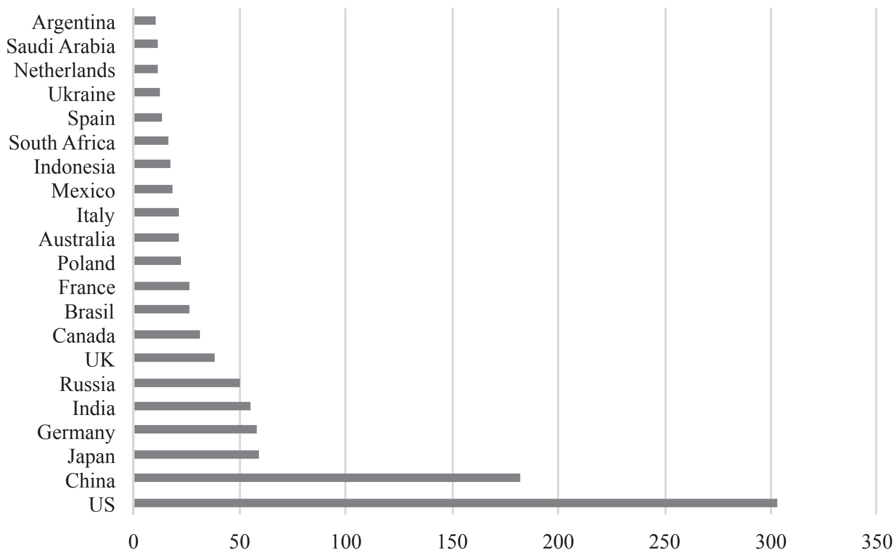
Each IMF member country thus becomes a shareholder in the Green Climate Fund proportionally to its contribution in SDRs. A country’s participation could be increased through contributions from publicly owned development banks designed to support countries receiving loans and subsidies from the Green Climate Fund (for example, the Agence Française de Développement, or AFD). Public banks could contribute to the Fund’s equity capital and participate in its governance. Independently of this option, one possible scenario is that the quota of shares held by a country be proportional to its IMF weighting. The shareholding structure of the Fund would then reflect that of the IMF, which was rightly amended in 2010 to give slightly more weight to emerging countries. In concrete terms, this would mean that low-income countries (the least advanced countries) would contribute almost nothing to the Fund, whilst the ‘advanced’ countries would be the main contributors. The United States’ contribution, for example, would be around 18%, whilst France, Germany and the United Kingdom would contribute between 4% and 6%. China would contribute 4%, India 2.4%, Brazil 1.8% and Mexico 1.5%.

1.2. The Global Climate Fund's equity capital

Without any other adjustments, however, a breakdown of this kind would probably run into opposition from a number of Southern countries and from international NGOs, which want to see Northern countries assume more of their historic responsibility for the accumulation of GHGs already emitted. Given that most international climate negotiations have stumbled over this point, contributions from the 'advanced' countries should be structured so as to more effectively reflect their share of responsibility. We therefore propose the following breakdown:

- According to the scheme put forward by the IMF in 2010, the Green Fund should have an equity capital of US$100 billion. We propose that this equity capital be provided solely by the 21 countries responsible for the bulk of cumulative GHG emissions.[4] According to data from The Shift Project (TSP) portal, the list of 21 countries contributing to the bulk of GHG emissions between 1961 and 2010 is given in Figure 22.2 (see the Appendix for further details).

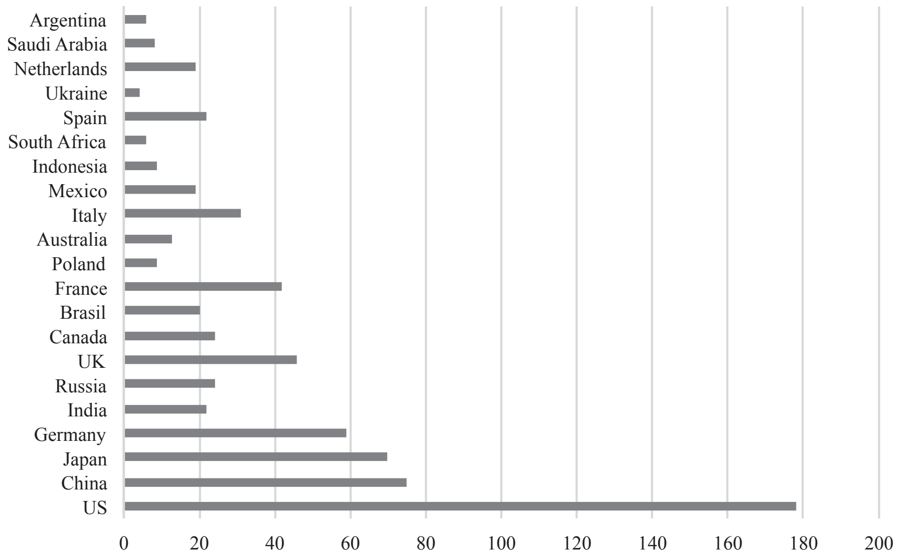
Figure 22.2. *Relative share of GHG emissions, 1961-2010*



We should also note the relative quotas of IMF member countries, as given in Figure 22.3.

4 It would also be possible to correct these emissions on the basis of imports/exports to take into account the fact that some countries emit GHGs for consumption by citizens of third countries.

Figure 22.3. *Share of the IMF (%*100)*



- The top 20 countries responsible for GHG emissions would contribute to the Green Climate Fund's equity capital in proportion to their cumulative contributions within the 'G21'. The United States' contribution relative to this list, for example, would be 30.27%, whilst France's would be 2.62%. Their contribution would be made on the basis of SDRs taken from their 2009 allocation. In other words, the contribution from low-income countries to the Green Climate Fund's equity capital would be nil; the contribution from 'advanced' countries would be taken from the exceptional allocation of SDRs in 2009, in proportion to their relative weight in the group of 'advanced' countries.

Nevertheless, this bias in contributions to the Fund's equity capital would not be reflected in the Green Climate Fund's governance structure, which would be based, for instance, on the principle of 1 country = 1 vote. It should however be clear that our proposal does not hinge on this type of institutional arrangement. The system used should above all facilitate diplomatic implementation of the process, whilst ensuring a minimum level of fairness. Furthermore, when making their initial contributions to the Green Climate Fund's equity capital, the 'advanced' countries would forego any form of dividends.

Finally, IMF regulations require that SDRs remain liquid: each contributing country – in this case, the 'advanced' countries – must be in a position to exchange them at any time against one of the four national currencies into which SDRs are convertible on the markets. This means that an additional 'cushion' will be necessary, for the initial contribution, in order to fund any conversions that may be required by some member countries. The IMF note (IMF, 2010) calculates this requirement at 20% of the initial total equity endowment of

US$100 billion, thus raising the amount to US$120 billion – equivalent to just 4% of the total exchange reserves of the 'advanced' countries. As a result, the United States' contribution, for example, would be US$36.324 billion and that of France US$3.144 billion, or approximately €2.42 billion. As far as France is concerned, an amount of this size would hardly drain its current foreign exchange reserves (US$195 billion). The same would be true of China, whose contribution would be US$21.88 billion, compared with reserves of nearly US$3,000 billion. Numerous other ways of calculating the breakdown of contributions are possible.

Finally, we should note that SDRs constitute unused foreign exchange reserves as long as they are not converted. Transferring them to the Green Climate Fund as equity capital would therefore not have any immediate macroeconomic impact. The only consequence of the transaction would be a reduction in the *potential* foreign exchange reserves of G21 countries. This would become problematic in the event of a new international financial crisis or a foreign exchange crisis, which often go hand-in-hand, as illustrated by the 1997-98 events in Southeast Asia. It seems clear to us that it would then be up to the IMF to intervene on an ad hoc basis, as it did in 2009.

2. Possible operating methods for the new tool

2.1. Green loans

The equity base of the Green Climate Fund authorises it to issue green 'bonds'. The cash raised by private investors (e.g. institutions) is then lent by the Fund as long-term, low-interest loans to the 'least advanced' countries for green infrastructure projects. Loans carrying environmental conditions are transferred as SDRs to the recipient country's central bank, which then converts them into the national currency. Needless to say, numerous procedures could be put in place both downstream and upstream of the tool, including public-private partnerships, the setting-up of recipient institutions with a mixed shareholder structure similar to the French EPICs (industrial and commercial public establishments), and so on. One of the main questions that need to be asked is the following: how is it possible to ensure that such loans do not drive the countries receiving them into a further period of debt which, as the dramatic experience of the 1980s and 1990s showed, can lead to deadlock? Also, loans from the Green Climate Fund could usefully be combined, upstream, with loans from the International Development Association (IDA), the fund run by the World Bank. We will not explore these eventual linkages in detail here, as the aim of this chapter is simply to suggest that it is *possible* to envisage ways of financing the Green Climate Fund that would be relatively affordable for the Northern countries, whilst responding to legitimate demands from the South.

If we accept, as does the IMF (2010), that the default rate on loans follows a Gaussian distribution around 5% with a standard deviation of 1.5 percentage points, then there is a 99.9% probability that an equity base of US$100 billion would cover losses from outstanding loans totalling US$1,000 billion. This equates to a leverage ratio of 10.

We also propose that all IMF member countries provide government backing for Green Climate Fund loans not covered by the Fund's equity base (i.e. US$880 billion), this time in proportion to their IMF quota. Again, this would mean higher off-balance sheet contributions from 'advanced' countries than from the other countries. On this count, it might not be inapposite to *also* invite the 'least advanced' countries to offer their own government backing in order to limit the 'free-rider' effect. The 'free-rider' phenomenon could occur, for instance, were a country to accept transition projects financed by the Fund's loans without carrying any of the risk associated with the project, whilst in parallel it had a disproportionate say in the governance of the Fund.

Guarantees from member countries would, in addition, help the Green Climate Fund to reduce the interest rate on its debt and thus reduce the rate of return required from investments funded by Green Climate Fund loans. It would also help to increase the leverage ratio. In the rest of this chapter, however, we will continue to work on the assumption that the Fund raises US$1,000 billion over ten years. In this case, the government backing provided by the United States would be 17.816% x US$880 billion = US$156.78 billion. For France, government backing would amount to US$37.07 billion (approximately €28.52 billion). For comparison, France has provided over €70 billion in state guarantees for Dexia.

In all events, substantial efforts are required to support state loans and should be the responsibility of the international banking and financial institutions that have historically partnered the states. The AFD would naturally have a role to play in France.

Moreover, securitisation mechanisms for green loans could be envisaged, again to facilitate private funding.

Finally, as the debt issued by the Fund will enjoy the guarantee of the governments of all IMF member countries, it will serve as high-quality collateral for banks to refinance themselves with central banks. It is even conceivable that the Green Climate Fund's 'green bonds' will become benchmark collateral in the years to come. They would then play a role that had been played by most sovereign debts until 2010 but that they can no longer assume today, threatening the entire edifice of the world's financial derivative assets.

2.2. Subsidies

The subsidies financed by the Green Climate Fund in our proposal would amount to US$60 billion a year. Among other innovative tools such as a tax on financial transactions, the IMF note (2010) envisaged funding them through carbon taxation or taxes on shipping or aviation (the so-called 'Chirac tax'). Given the change in context since 2010, we believe other tools can be envisaged.

- Tapping into existing SDR reserves: as we have said, the equivalent of US$176 billion was allocated to 'advanced' countries between 28 August and 9 September 2009. If US$120 billion are allocated to the Green Climate Fund's equity capital, this leaves US$56 billion that can be used to finance subsidies from the Fund. This could be mobilised to fund subsidies in the first year, when the project is in its start-up phase.

Similarly, the two previous SDR issues break down as follows: the first general allocation of a total of 9.3 billion SDRs was distributed over the period 1970–1972, and the second general allocation of 12.1 billion SDRs over the period 1979–1981, making a total of 21.4 billion SDRs. Since the G21 countries together account for around a 70% of IMF quotas, this means that they have received about 15 billion SDRs (equivalent to approximately US$18.5 billion). Ultimately, this leaves around US$74.5 billion available to the Fund to help with financing subsidies for its first years of operation.

- Unlike a loan, however, a Green Climate Fund subsidy does not entail interest payments or repayment of capital. This means that the additional allocation of SDRs would represent a net loss for contributing countries. We can assume that this would not be a popular funding option for the countries concerned.
- Finally, as the Fund's equity capital is constituted by SDRs transferred to it by the G21 countries, this means that they would also be required to pay interest on these SDRs in accordance with IMF regulations. The forecasts in the IMF note (IMF, 2010) were based on the assumption of a nominal annual interest rate for SDRs of around 2%. If these forecasts hold, and assuming a total equity endowment of US$120 billion, this would generate annual interest of US$2.4 billion on average. SDRs would therefore be 'serviced' by the 'advanced' countries and this would represent their actual annual budget contribution to the Green Climate Fund during its lifecycle. In the case of the United States, for example, this would represent annual expenditure of 30.27% x US$2.4 billion = approximately US$726 million (around €558.5 million). The annual cost for France would be around €48 million. This would be the only budget expenditure commitment for the countries (assuming no claims are made on public guarantees).
- All in all, if we take the view that the annual funding requirements for subsidies under the Green Climate Fund amount to US$60 billion, then 74.5 + 4.8 = US$79.3 billion funded w*ithout increasing the money supply*. Given the annual level of interest paid, the financing requirement for the Green Climate Fund would therefore be US$40.7 billion in year 2 and US$57.6 billion in the following years. This could be financed through an additional issuance of SDRs, on top of the contributions from member countries. This final issuance would represent a real increase in the money supply – but would be less than 0.05% of global GDP each year. The IMF's Articles of Agreement authorise it to undertake this type of issuance without a counterparty, in the same way that a central bank creates money. This would require the agreement of 85% of the IMF's member countries. Paragraph a) Section 1 of the article in the IMF Articles of Agreement that deals with SDR issues stipulates:

'In all its decisions with respect to the allocation and cancellation of special drawing rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of its purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world.'

Conclusion

In the introduction to this chapter, we mentioned a few wordings that make it easy to suggest that combating climate change falls fully within the IMF's mandate relating to its power to issue SDRs.

On the basis of these observations, this chapter proposes a way of funding the Green Climate Fund's equity capital that would enable the Fund not only to fulfil its mandate but also to respond to the political demand from countries in the South that the 'historic polluters' be the main financial contributors, whilst at the same time limiting to the utmost the impact on the budgets of Northern countries. The main thrust of the proposal is to mobilise the IMF currency. This, of course, implies a level of risk-taking by the Northern countries: in the event of a new financial maelstrom, some of the foreign exchange reserves allocated to them in 2009 would no longer be available, as these will have been invested in the Green Climate Fund. Nonetheless, the risk is minimal for two reasons. First, as we have seen, the proportion of foreign exchange reserves actually invested in the Green Climate Fund is still minimal for most contributing countries. Second, even if financial turmoil akin to that of 2007-2009 reoccurs, there is little doubt that the IMF, if approached, would be in a position to provide countries in need with SDR.

Given the political hurdles to gaining acceptance for financing by increasing money supply (particularly in the eyes of the US Congress), we suggest that the French government, as the organising institution of COP21, simply 'back' the proposal to finance the Green Climate Fund's equity capital through existing SDRs. This would not involve increasing the money supply and would make it possible to fund US$100 billion of annual loans over ten years at a minimal cost for the 'advanced' countries, with the 'historic polluters' nonetheless remaining the main contributors.

Box 22.1. *...and the inflationary risk?*

The inflationary risk related to the creation of SDRs over years 2 to 10 of the exercise is minimal, given:

- the very low proportion of additional money that creating SDRs represents relative to global GDP; and
- the 'output gap' (i.e. the difference between actual GDP and potential GDP) in industrialised countries. In the medium to long term, industrial production facilities in both North America and Europe have been operating at an average of just 81% of capacity. Increasing the money supply therefore only presents an inflationary risk when the usage rate of industrial production facilities exceeds 81%. It is currently less than 78% in both the United States and Europe. Clearly, therefore, there is no inflationary risk at the global level.

Would the emerging countries (which would be the main recipients of an influx of money) run an inflationary risk at a more local level? The current context suggests that any risk would be very low. The abundant liquidity created in the West since 2009 to overcome the liquidity crisis in the banking sector has, to a large extent, been poured into the emerging countries. Attempts by the Fed to tighten monetary policy threaten to stem this flow. The drying-up of the money supply is all the more marked insofar as most emerging countries themselves had to step up the amount of their national currency in circulation in order to prevent it from increasing in value, as the Fed's unconventional policies of quantitative easing were bringing down the value of the US dollar.

Finally, the abundant liquidity in the West has caused significant inflation in some emerging regions and made the real exchange rate in these economies less and less competitive. This is illustrated by the trend of shifting capital, this time, to Western countries in 2013. Today, the emerging countries are thus being forced to combat *deflationary* forces, which affect them by devaluing their currency and obliging them to 'export' their deflation. Furthermore, Japan, which has been effectively bankrupt (in both the public and private sectors) and bogged down by deflation for over 20 years, is now trying to devalue the yen so that it too can export its internal deflation.

Box 22.1. *(contd.)*

The inevitable tightening of monetary policy at the Fed, combined with the devaluation of the yen, would lead South Korea to devalue the won, then Thailand the baht, and so on. Once Asia embarks on an external adjustment process, other emerging zones will need to devalue in turn, in particular Brazil. Finally, China, whose real exchange rate is less than competitive, will not be able to adjust the yuan downwards. Funding green infrastructure projects in emerging countries, including by issuing new SDRs, is the 'right' macroeconomic response to a tricky situation. It in fact enables the renewal of economic activity in countries threatened by a deflationary spiral. (We should remember that combating deflation is part of the IMF's mandate.) It does so essentially by creating a financing circuit (the Green Climate Fund backed by the IMF) that will make it possible to re-inject the liquidity being once again invested in the North *into the Southern countries*. And it does so, in a very marginal way, by increasing the money supply via a process (subsidisation) that does not strain the public finances of Southern countries and which, in the latter's deflationary context, entails a negligible inflationary risk.

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Appendix: Country contributions to the Green Climate Fund compared to their IMF quota

Country	Contribution to cumulative GHG emissions (1961-2010) / relative contribution	IMF quota
1. United States	25.4% / 30.27%	17.816%
2. China	15.3% / 18.24%	7.474%
3. Japan	4.9% / 5.84%	6.987%
4. Germany	4.9% / 5.84%	5.888%
5. India	4.6% / 5.48%	2.184%
6. Russia	4.2% / 5%	2.434%
7. UK	3.2% / 3.81%	4.584%
8. Canada	2.6% / 3.1%	2.423%
9. Brazil	2.2% / 2.62%	1.969%
10. France	2.2% / 2.62%	4.213%
11. Poland	1.9% / 2.26%	0.910%
12. Australia	1.8% / 2.14%	1.326%
13. Italy	1.8% / 2.14%	3.098%
14. Mexico	1.5% / 1.78%	1.864%
15. Indonesia	1.4% / 1.67%	0.903%
16. South Africa	1.3% / 1.55%	0.587%
17. Spain	1.1% / 1.31%	2.243%
18. Ukraine	1% / 1.19%	0.407%
19. Netherlands	0.9% / 1.07%	1.898%
20. Saudi Arabia	0.9% / 1.07%	0.850%
21. Argentina	0.8% / 0.95%	0.591%
Total	**83.9% / 100%**	**70.649%**

23

All You Need Is Cash (for REDD+)?

ARILD ANGELSEN

There's nothing you can do that can't be done…
No one you can save that can't be saved…
All you need is love…
(The Beatles)

1. REDD+: EVOLUTION AND STATUS

Successful implementation of REDD (Reducing Emissions from Deforestation and Forest Degradation) or REDD+ (also including carbon stock enhancements) is critical if we are to limit global warming to 2°C. REDD+ has figured prominently on the international climate agenda ever since it was launched at COP 13 of the UN Framework Convention on Climate Change (UNFCCC) in 2007, and culminated with the adoption of the Warsaw Framework at COP 19 in 2013. In the early days (2007-2009), the principal funding source was assumed to become the carbon market. The Bali Action Plan (COP 13) was, in the view of key actors, a plan to make REDD+ part of a global climate agreement whereby REDD+ credits could be sold as offsets in a global cap-and-trade (CAT) system. By one estimate, the global mitigation costs in 2020 in a 2°C scenario are 57% higher when REDD+ is excluded from a carbon market compared to when REDD+ is included (Angelsen *et al*., 2014).

REDD+ would in this way address the fundamental problem of excessive emissions: forests produce climate services in the form of carbon sequestration and storage. These are public goods that currently have no markets or market-like mechanisms to incentivise the forest owners and users to factor the value of these services into their decisions. REDD+ is an attempt to correct this market failure by creating a multilevel (global – national – local) system of payments for ecosystem/environmental services (PES) (Angelsen and Wertz-Kanounnikoff, 2008). This could be made possible by large-scale financial flows from developed to developing countries, possibly in the range of US$10-15 billion per year, in order to reduce deforestation by 50% and with a payment of US$5 per tCO_2 (Stern, 2006; Angelsen, 2013). In this way, REDD+ could channel the global willingness to pay for climate services down to the land users, and make local decision-makers 'internalise the externalities' of deforestation and forest degradation. With REDD+, forest owners and users can simply sell forest carbon credits and sell less cattle, coffee, cocoa or charcoal.

The reality is now different. Since 2007, REDD+ has changed in several significant and interrelated ways (Angelsen and McNeill, 2012). First, COP 15 in Copenhagen (2009) failed to deliver the CAT system that was supposed to finance REDD+. The Durban Platform (COP 17) says that an agreement should be ready by 2015 (COP 21 in Paris) and take effect from 2020 (UNFCCC, 2011). Yet, it remains highly uncertain to what extent carbon markets will ever become a major source of international (and possibly also national) funding for REDD+. As a result, 90% of funding is currently coming from public sources, in particular development aid budgets (Norman and Nakhooda, 2014).

Second, REDD+ has moved from a carbon focus to become multi-objective, with livelihoods/poverty, biodiversity, adaptation, indigenous rights and good governance added as relevant objectives (commonly referred to as ‘co-benefits’ or ‘non-carbon benefits’). REDD+ is also increasingly linked to the agriculture and climate agenda.

Third, the domestic policy focus has changed from PES to broader policies. This change has been driven by several factors, including the lack of a new international climate agreement (making carbon market funding unavailable), the numerous challenges of establishing a PES system, and the political dynamics of REDD+, where different interest groups have inserted their own agendas into the global and national REDD+ agendas.

Today, REDD+ should therefore be understood as a hybrid set of policies, programmes and projects on all scales that aims to reduce emissions and increase removals (sequester carbon) from forests in developing countries. The PES idea has survived and results-based payments are seen as a key component of REDD+ policies and projects, but alongside other instruments and in a modified form (de Sassi *et al.*, 2014). REDD+ currently shares many characteristics of previous efforts of conditional and results-based aid. The lack of market finance spurred this ‘aidification of REDD+ (Seymour and Angelsen, 2012). Further, many donors were involved in the REDD-relevant sectors (forest, conservation, rural development, institution building, etc.) and ongoing activities could, with light modifications, be relabelled as REDD+ and tap into new budget lines. Moreover, the aid sector already provided a mechanism and modality to transfer fresh REDD+ money to recipients.

The key idea of REDD+ as aid is to apply conditionality and make payments to countries (or sub-national programmes) based on performance. In Section 2 of this chapter, I distinguish between two forms of payments: payments based on successful policy and institutional reforms, and payments based on direct results (corresponding to Phase 2 and Phase 3 of REDD+, respectively). The section also reviews the current REDD+ funding situation. Section 3 reviews three challenges of implementing such a results-based system, related to budget spending pressure, performance criteria, and reference levels. The final section provides some thoughts on the way forward.

2. REDD+ PHASES AND FUNDING

2.1. The phased approach to REDD+

The challenges of designing and implementing a pure PES system, and the fact that the capacities of the REDD+ countries differ enormously, led to the introduction of the phased approach of REDD+. The approach was developed through a consultative process, presented in Meridian Institute (2009), and later adopted by the UNFCCC. The three phases are:

Phase 1 – the readiness phase: The initial phase focuses on developing national REDD+ strategies and policies, capacity building and demonstration activities. Establishing appropriate institutions for REDD+ implementation is critical, including reliable systems for MRV (monitoring, reporting and verification) and managing REDD+ funds.

Phase 2 – policy reforms and result-based demonstration activities: The second phase focuses on the implementation of national policies and measures, as well as demonstration activities on the ground that use results-based payments (based on verified reductions in emissions). International support might be related to policy implementation.

Phase 3 – results-based actions and payments: The last phase involves moving into a system of results-based actions and payment, both for international funding and possibly also for the national disbursement of REDD+ finance.[1] Emissions and removals should be fully measured, reported and verified by an authorised third party, with the payments coming from either carbon markets, the private sector or public sources.

The phased approach is useful in several ways. An important justification for its adoption was that it enables countries to access REDD+ funds whatever stage they are at; for example, countries with poor MRV systems and not ready for Phase 3 can still get support for the development of such a system (Phase 1). It also provides incentives for graduation. The phased approach is used as an organising principle in the 2010 agreement between Norway and Indonesia.

2.2. Earlier experiences

The phased approach also forms a useful background for the discussion of different performance-based payments. Phase 2 is intended to be a '*reforms for cash*' phase, with similarities to earlier programmes of conditional aid/lending. Conditional aid was part of the Structural Adjustment Programs (SAPs) from the mid-1980s, led by the World Bank and IMF. Disbursement of aid money was to be conditioned on deep policy reforms, but the performance of performance-based aid was mixed: 'This is indeed the core of what conditionality is supposedly about – aid buys reform. Unfortunately, it does no such thing' (Collier, 1997, p. 56). Similarly, Killick (1997, p. 493) states that '[c]onditionality is not an

1 Some observers restrict the results-based payments of Phase 3 to the international payments only, maintaining that the countries themselves should decide how to achieve these results. This principle of 'implementation neutrality' of international agreements has, nevertheless, been weakened in REDD+, with much of the debate and COP decisions being on national REDD+ implementation (social safeguards, for example).

effective means of improving economic policies in recipient countries'. Although the prospects for 'reforms for cash' may appear to be rather dim, the experiences of conditional lending during the period of SAPs is relevant for REDD+. It sheds light on some of the fundamental issues, to which we return in Section 3.

Phase 3 of REDD+ implementation is intended to be a '*results for cash*' phase. The results are, simply, 'REDD' – reduced emissions from deforestation and forest degradation. Again, REDD+ as a results-based payment is not too different from other results-based schemes. The key to all such schemes is 'a contract between both parties that define incentives to produce measureable results' (Klingebiel, 2012, p. 3). The three critical elements are: (i) payments based on results, (ii) recipient discretion (the recipient decides *how* to achieve results), and (iii) independent verification of results (Perrin, 2013). Perakis and Savedoff (2014) add two elements that also characterise results-based aid (RBA): (iv) public dissemination of the contract and outcomes to ensure transparency; and (v) RBA funding being normally complemented with other (non-results-based) sources of funding.

There is a clear international trend to move from 'promise-based' to 'results-based aid' (Öhler *et al*., 2012; Klingebiel and Janus, 2014). The 2005 Paris Declaration on Aid Effectiveness (OECD, 2005) called for more aid to be based on actual performance or results, and a more recent focus is on RBA. A good policy approved by parliament will have limited or no impact if not properly implemented. Results-based performance indicators provide strong incentives for effective policy implementation and generate results on the ground. RBA and results-based financing (RBF) have therefore been applied increasingly in other sectors, in particular in health (Eldridge and Palmer, 2009; Eichler *et al*., 2009; Grittner, 2013) and in primary education (Birdsall *et al*.; 2011). The World Bank has supported results-based funding in the health sector for more than 20 years (Perrin, 2013), and most of the current experience is from that sector.

In a review of output-based aid (OBA) (a term used in a very similar way to RBA) in the health sector, Eldridge and Palmer (2009) find that most studies appear to be positive towards OBA, in spite of a lack of firm evidence, including the use of proper controls; the evidence is more anecdotal than based on rigorous impact assessments. A review of payment-by-results (PBR) evaluations conclude that 'the value of PBR is, at least as of yet, unproven' (Perrin, 2013, p. iii). The momentum for RBA therefore seems to reflect attractive theoretical properties and perhaps also a political fad, rather than solid empirical evidence on greater effectiveness.

2.3. Current REDD+ funding

Alongside the changing perceptions of what REDD+ should be are signs of slowdown in REDD+ finance, as documented by Norman and Nakhooda (2014). Before COP 15 in Copenhagen (2009), the dominant thinking was that we needed public money to keep up momentum 'before the carbon market takes over from 2012'. That takeover never took place, and perhaps never will. Of the approximately US$8.7 billion of international funding for REDD+, 65% was

pledged between 2006 and 2010. Since 2010, average annual pledges have been US$605 million.

While donors, notably Norway and Germany, have pioneered performance-based funding, at least 61% of the public funding pledged so far is for readiness activities (the first REDD+ phase). The Norman and Nakhooda (2014) stock-taking also points to several other noteworthy characteristics:

- Public finance dominates completely, with close to 90% of the finance.
- Five donor countries dominate (Norway, the US, Germany, Japan and the UK), with three quarters of the funding between them. Norway alone, the REDD+ superpower, accounts for US$3.5 billion, or 41%, of the US$8.7 billion pledged.
- Two countries – Indonesia and Brazil – are set to receive about 40% of the funding. The share is justifiable, however, based on their share of tropical forest cover and emissions.
- The accumulated forest carbon market offset transactions come to some US$900 million. (Peters-Stanley *et al.*, 2013).

This current funding situation for REDD+ entails several paradoxes. The pledged amount represents an unprecedented level of funding to a single environmental effort in developing countries. Yet, the current annual pledges make up only some 5% of the previously mentioned US$10-15 billion per year 'needed' if the international community is to compensate developing countries for a 50% reduction of deforestation. From this perspective, there is a huge funding gap. On the other hand, there is also a disbursement problem (Streck and Parker, 2012). A leading development agency official told me in 2011 that '[y]ou simply cannot imagine how hard it is to spend money on REDD+'. Development agencies should, however, not be criticized for spending too little; the problem is rather 'spending pressure', as discussed below.

3. Challenges of designing and implementing conditional payment schemes[2]

Designing and implementing either a '(policy) reforms for cash' or a 'results (emission reductions) for cash' system is much more difficult than often perceived in policy circles.

This section focuses on three challenges: spending pressure, performance criteria, and reference levels. This list is not exhaustive, and additional challenges include the following:

1. *Balancing multiple goals* (i.e. carbon versus non-carbon benefits), in particular since most of the current international REDD+ funding is development aid that has poverty reduction as its primary goal.
2. Avoiding potentially adverse *distributional implications*, where the emphasis on well-functioning systems for measurement and verification

2 This section draws heavily on Angelsen (2013).

may exclude poorer individuals/communities/countries (Klingebiel and Janus 2014).

3. Managing uncertainty and *risk-sharing*, as a results-based system tends to shift the risk to the service providers (Mumssen *et al*., 2010), particularly in situations where exogenous factors strongly influence the outcomes. Mechanisms can be designed to ensure risk sharing, for example, *ex post* adjustment of reference levels and the 'corridor approach' of gradually increasing payments for larger emissions cuts (Angelsen, 2013).
4. Putting *sufficient money* behind the results-based contract in order to make the recipient believe walking an extra mile will be rewarded fully. If the contract is not fully backed by financial resources, the payment will be a lump sum, without the *marginal* incentives it intends to create.

3.1. Challenge 1: Budget spending pressure

Spending the annual budget is a key goal for any agency or bureaucratic organisation. Under-spending is viewed by the public as reflecting poor planning and performance. Under-spending also signals that there is no need for the current budget allocation, and therefore carries a high risk of cuts in future budgets. Within organisations, bureaucrats are promoted based on disbursement and overall spending.

Spending pressure makes a performance-based contract less likely to succeed. Consider a contract between an aid donor and a developing country government. The donor wants reforms and also to spend the budget, while the recipient does not want to reform but, obviously, wants to receive the money. A conditional contract is made stating that the payment is to be made if, and only if, the reform is undertaken by the recipient. If we consider this a simple three-stage game (contract, policy reform and payment) and solve it backwards, as is commonly done in game theory, the surprising equilibrium solution is this: a performance-based contract is signed, no reforms are undertaken, and the payment is made.[3] The explanation is simple: the donor has an interest in spending, and will do that at stage 3 whatever the recipient has done at stage 2. Knowing this, the recipient will *not* undertake any reforms. Although a simplified model, it reflects an important aspect of donor-recipient relationships and why donor insistence on performance-based payments may not be credible. An analysis of conditional lending (including SAPs) by the World Bank concludes that the degree of compliance with the conditions in the aid agreement had no impact on the actual disbursement (Svensson, 2003). Conditionality often fails due to the budget spending pressure.

3 See Mosley *et al*. (1987) for the original discussion, and Angelsen (2013) for a simplified model. Obviously, more complex models can modify the result presented here; see, for example, Svensson (2003).

The key to changing this situation is to create an *opportunity cost of spending*. First, disbursement should be detached from the annual budget process, for example, though multi-year funds. Annual budget processes can make the opportunity cost *negative*, i.e. not spending this year can lead to lower future budgets. Second, generating a positive opportunity cost for disbursements can be achieved by creating competition among recipients for scarce aid funds. Third, donor credibility can be enhanced by making a third party responsible for assessing performance and deciding on disbursement.

Further, donors may try to increase the recipients' willingness to undertake policy reforms, often referred to as recipient country governments assuming 'ownership' of the policy reforms. While efforts to create country ownership of REDD+ reforms may be implemented alongside RBA, the underlying rationale of RBA is that the *external* incentives will provide the necessary impetus for reforms. Also, in the context of REDD+ there is a fundamental divergence in interests: reduced emissions produce a global public good, and each country does not have sufficient incentives to contribute to this.

There are nuanced views in the literature on the degree to which (conditional) aid can influence domestic policy-making. Some argue that donor conditionality plays a minor role, compared to domestic politics, in determining the choice and implementation of policy reforms (Burnside and Dollar, 2000). According to Collier (2002, p. 7): ' … the "aid for reform" approach takes a hopelessly naïve view of the reform process and of the game being played'.

Others question the assumption of a monolithic government, which does not allow for multiple actors with different agendas. A study on conditional lending in the forestry sector concludes that: 'The cases in this report demonstrate that under the right conditions, the World Bank has been able to catalyze key forest policy changes in the context of adjustment lending, tipping the scales toward reformist elements and away from vested interests. Under the wrong conditions, the World Bank's efforts have been met with frustration for both it and the borrower, and have led to a stalemate in the reform agenda' (Seymour and Dubash, 2000, p. 2).

We have focused on the spending pressure in relation to policy reforms (Phase 2), but the pressure is also present in Phase 3. It may, however, be easier – with flexible interpretations of performance – to justify spending on policy reforms than on more specific results.

3.2. Challenge 2: Performance criteria and measurement

The commonly used logical framework approach (LFA) provides a useful lens for the discussion on the selection of performance criteria and their measurements (Table 23.1). The LFA can be linked directly to the phased approach of REDD+: moving through these phases implies that donors move from supporting inputs and activities to outputs, and finally to outcomes and impacts.

There are strong theoretical arguments for selecting performance criteria as far to the right in the table as possible. Reduced emissions is the primary goal of REDD+, and performance should be measured as directly as possible. Input-

Table 23.1. *A results chain illustrating the REDD+ performance criteria from input to impact.*

Level	Input	Activity or process	Output	Outcome	**Impact**
Focus	Quantities of various inputs, in values or time	Activities undertaken to produce specific outputs	Immediate/technical results of intervention	Intermediate and mid-term effects, i.e. observable behavioural, institutional and societal changes	Broader and long-term effects, often captured in sectoral statistics
Terms	Input indicators	Process indicators and milestones	Output indicators	Results indicators; outcome indicators	Impact indicators; goal indicators
REDD+ examples	Resources spent (US$); technical assistance (person days)	National REDD+ plan completed; Free Prior Informed Consent (FPIC) consultations conducted	Policies adapted and enforced; a number of loggers adapted reduced impact logging practices	Reductions in deforestation; reductions in unsustainable timber harvest	Certified/verified changes in GHG emissions
REDD phase	Phase I	Phase II		Phase III	

Source: Based on Wertz-Kanounnikoff and McNeill (2012); see also Klingebiel (2012).

or process-based measures are generally poor indicators of the final impact (Mumssen *et al*., 2010). Another challenge is to focus on a limited set of criteria and avoid the 'Christmas tree' approach: ornaments (i.e. criteria) are added to make it look nice, but in the process we lose sight of the key objective (the trunk of the tree, where most of the carbon is!).

Moving towards impact criteria is normally more data-demanding. For example, whether or not a forest has been legally designated as a protected area (an output) is easy to verify; measuring the area of deforestation (another output) over a specific time period is harder, but doable with time series of satellite images. To measure emissions (impact), one also needs emissions factors for deforestation (emissions per hectare following the change in land use/cover). Another issue is the time lag between the (costs of) actions and the payments. The further along the results chain one moves, the longer the time lag (Wertz-Kanounnikoff and McNeill, 2012). This represents a challenge for fiscally constrained REDD+ governments and projects, and also demands high levels of trust that payments eventually will be made. Other solutions may include making some up-front payments that are not results-based, and then making regular (annual) payments based on interim progress.

Effective RBA implementation requires appropriate institutions, accounting and verification mechanisms. Introducing emission-based payments without these preconditions in place might increase the scope for 'gaming' of results, undermining the effectiveness and credibility of the system. Starting with easier-to-measure policy outputs and processes might therefore be a better short-term option in weak institutional environments.

3.3. Challenge 3: Reference levels

All performance-based payments require a benchmark – a yardstick against which performance is measured. Establishing that benchmark or counterfactual is the critical issue in all forms of impact analysis, and even in research that tries to establish causality. This problem can also be viewed as an *attribution* problem, i.e. determining whether an output/outcome/impact is a result of the intervention or other external factors. In general, such external factors play a larger role as one moves to the right along the results chain, and setting benchmarks therefore becomes increasingly difficult.

Reference levels are important for both Phase 2 and Phase 3 of REDD+, although most of the following discussion deals with Phase 3. For Phase 2, the typical assumption underlying RBA is a baseline of 'no policy reforms', although policies are constantly changing even without REDD+. Thus the business-as-usual (BAU) scenario, here defined as a scenario without REDD+, would rarely be a simple extrapolation of the past.

The term 'reference level' (RL) in the REDD+ debate has two fundamentally different meanings (Angelsen, 2008). First, it can refer to the projected BAU scenario, which is the benchmark for estimating the impact or effectiveness of the REDD+ measures implemented (and ensuring additionality). Second, the reference level can refer to the *crediting baseline* (CB), which is comparable to

an emissions quota. The CB (also referred to as the 'compensation baseline' or 'financial incentive benchmark') is the benchmark for rewarding the country (or project) if emissions are below that level or for not giving any reward or possibly invoking debits if emissions are higher (depending on liability).

The question of establishing BAU baseline reference levels has been discussed extensively elsewhere, including an analysis of the relevant drivers.[4] The simplest proposal in the REDD+ debate is to assume BAU deforestation to be a simple extrapolation of the recent past. The reference period is typically set as the average deforestation rate of the last ten years, and updated every three or five years (Santilli *et al*., 2005). This is the formula used by the Amazon Fund and was adopted in the 2008 Norway-Brazil agreement on REDD+. Simple historical extrapolations are also likely to dominate in countries' submission of forest reference emission levels to the UNFCCC.

Deforestation can be highly variable from year to year, but it can also display systematic trends over longer periods (five to ten years) that depart from past deforestation. The forest area change may follow a pattern suggested by the forest transition (FT) theory[5] whereby in the early stages of the development, a country is characterised by high forest cover and low deforestation rates. Deforestation then accelerates and forest cover is reduced, before the deforestation rate slows down and forest cover stabilises and eventually starts recovering. A simple extrapolation of historical rates therefore tends to *underestimate* future BAU deforestation for counties at the early stages in the transition, while it tends to *overestimate* BAU deforestation for countries at the later stages.

The second main question under the heading of reference levels is how to set the crediting baselines, which form the basis for rewarding successful REDD+ efforts. This decision goes well beyond the technical issues, and concerns how the costs of global emissions reductions should be allocated among (and within) countries. UNFCCC has adopted the principle of 'common but differentiated responsibilities', but the interpretation of this remains among the most controversial issues in climate negotiations.

Overall, setting reference levels is among the most challenging issues in a results-based system. The fluctuating nature of deforestation, reflecting the complexity of drivers and instable political, economic and ecological environments, makes it particularly challenging to predict forest-based emissions. Moreover, there are potential incentives to set reference levels for emissions high to make policies look more successful than they are and/or to receive more funding. On top of this, spending pressure from donors may result in unrealistically high reference levels. Some of the payments may therefore not be additional. If REDD+ credits are to be traded in a carbon market, the result will be 'hot air', i.e. fake emission reductions that contribute to more global warming in a CAT system.

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4 See reviews by Angelsen and Kaimowitz (1999); Geist and Lambin (2002); Rudel (2007) and Hosonuma *et al*., (2012).

5 See Mather (1992); Rudel *et al*., (2005); and Angelsen (2007).

4. A WAY FORWARD

The safest way to predict tomorrow's weather is to say that it will be the same as today. The same is true for REDD+ finance for the rest of this decade. At the international level, public sources will most likely dominate. Funding is likely to shift from capacity building, which currently dominates, to various forms of performance- or results-based support, but it will most likely not be the PES system that many initially envisaged. Carbon markets as a source of REDD+ finance might develop further, but this depends largely on policy decision made at future COPs and by a few big countries. What are the lessons one should bear in mind as REDD+ continues to evolve?

First, results-based aid and funding is a good idea, but 'the governing is in the details'. Policy-makers need to have a realistic picture of the challenges and what RBA can achieve. It has certain strong merits, but poses serious challenges (as outlined in this chapter) that must be addressed up front. The challenges that arose in other sectors when trying to implement RBA are highly relevant to REDD+, but the options and lessons provided are rarely brought into the REDD+ debate. They should be.

Second, donors should create mechanisms to increase the opportunity cost of funds. The spending pressure from donors is a major reason why conditional or performance-based payments have not been credible or worked in the past. Such mechanisms can include multi-year funds, competition ('aid tournaments') among recipients, or handing over disbursements to third parties with clear instructions.

Third, we need to be realistic about private sector funding of REDD+. Much of the discussion in climate finance, including REDD+, is on bringing the private sector on board. I agree that we should. However, we should not be naïve about how markets and the private sector work. The basic climate problem is this: each of us does not have sufficient incentives to produce the global public good in question, namely a stable global climate. This collective action (or externality) problem can be corrected by carbon taxes or a cap-and-trade system. Voluntary actions are not sufficient. The voluntary carbon market is minuscule compared to the EU's Emissions Trading System (ETS) and the Clean Development Mechanism (CDM) market (at least, compared to what it used to be before the recent collapse). Private demand for carbon credits on any significant scale is created by policies and legislation; it does not come from the private sector itself. Likewise, the prospects for large-scale investments in REDD+ are limited, due to the very nature of REDD+ (essentially, conserving forests). While eco-tourism and eco-products such as shade-grown coffee can provide good (but isolated) examples of profitable investments compatible with forest conservation, their scale is dwarfed by current aid levels and the prospects for REDD+ funding from compliance carbon markets.

Fourth, successful REDD+ implementation needs more than just cash. In 2007, the Center for International Forestry Research (CIFOR) published the first in a series of REDD+ books titled, *Do Trees Grow on Money?* (Kanninen *et al*., 2007). The book did not give a clear 'yes/no' answer to this question;

money can fertilise the soil, but a number of other factors matter. More than one thousand quantitative studies on the aid-growth link (Doucouliagos and Paldam, 2011) have shown that the link between international funding and development outcomes is ambiguous. While cash can talk, it may not always walk. The focus needs to shift from the level of international finance and spending to deeper policy reforms and on the results.

Finally, REDD+ was originally envisaged as a giant, multi-level PES scheme to save tropical forests and thereby keep the carbon stored in the trees and soil. That scheme has not taken off. In a review of sub-national initiatives in six major REDD+ countries, de Sassi *et al.* (2014, p. 424) conclude that '[i]f REDD+ is defined as conditional cash payments to landholders, then clearly most initiatives have failed'. REDD+, as an objective rather than a particular policy (i.e. PES), will therefore be implemented in a variety of forms, hopefully integrated well and mainstreamed into development aid and green growth strategies.

REDD+ is to me still a very good idea. Interpreting REDD+ as an objective, we need to eliminate most forest emissions if we are to limit global warming to 2°C. Interpreting REDD+ as a policy instrument, I also think the basic idea underlying REDD+ is sound: create economic incentives for reduced emissions. But, a good idea has met the complexity on the ground, and the way forward will need to combine good ideas with a realistic assessment of what is feasible.

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24

Principles and Dilemmas in Mining Taxation

Bertrand Laporte and Grégoire Rota-Graziosi

'I was the richest man in the world but gold ruined me.'
L'Or. La merveilleuse histoire du général Johann August Sutter
(Cendrars, 1925).

In his novel, *L'Or. La merveilleuse histoire du général Johann August Sutter* (published in English as *Sutter's Gold*), Blaise Cendrars tells the story of Johann August Sutter, the owner of a vast farm in California who dies penniless and without property after gold is discovered on his land in 1848 (Cendrars, 1925). This novel based on a true story sets out some of the problems that contribute to the 'curse of natural resources', as Auty (1990) and later Sachs and Warner (1999) described the negative relationship between a country's abundance of natural resources and its economic growth.

The academic debate around the curse of natural resources underlined very early on the role of institutions in transforming the curse into a blessing (Mehlum *et al.*, 2006). Amongst these institutions, the tax system and its implementation by the various administrative authorities concerned certainly occupy a key position. They are not sufficient, however, to correct political instability or a defective legal system.

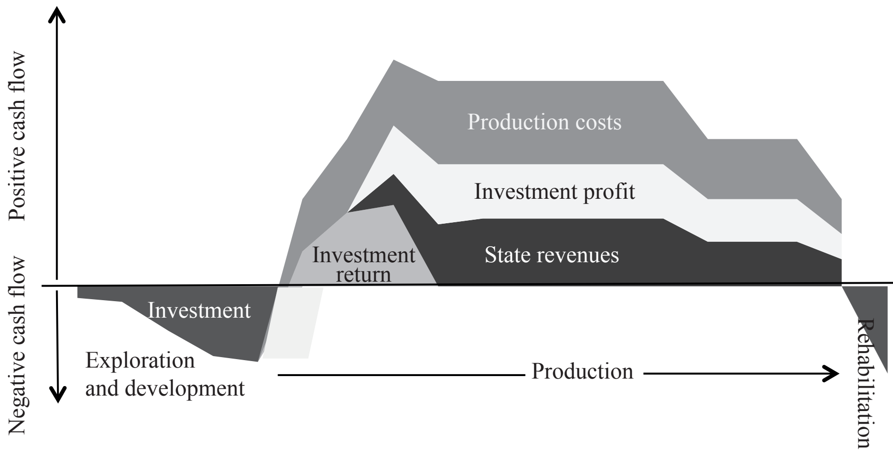
Numerous developed and developing countries have revised or have been revising their mining taxation for over a decade. This trend is linked to changes in the global prices for raw materials in general, and minerals in particular. World prices have remained steady in spite of the recent economic and financial crisis, stimulated by demand in Asia, particularly China, which is thought to be the main factor in a new super-cycle since the 2000s, comparable to those at the end of the nineteenth century in the United States and in 1945-1975 resulting from the reconstruction of Europe and Japan (Heap, 2005). Alongside the change in prices, the extractive industry has become concentrated in a few hands following a series of mergers and acquisitions.[1] It is now essentially controlled by major multinational groups that are able to invest significant amounts of money. Finally, there has been an upward trend in exploration, which reached a new record in absolute terms in 2012, with a total global budget (for all mineral resources) estimated at US$23.42 billion (SNL, 2013). This expenditure is concentrated

1 Whilst the ten largest companies in the sector accounted for nearly 20% of global mining production in 1990, this figure is currently nearing 40%.

in Africa, which overtook Canada in 2012 to become the second largest market for exploration expenditure behind Latin America (with 17% of the previously stated total).

Mining taxation needs to manage the delicate balancing act of attracting the international investors needed to generate mining revenue and ensuring such revenue is 'adequately' taxed. Mining rent, or economic rent, is the difference between the income generated by mining activities and the costs attributable to it, including 'normal' remuneration of the capital factor (see Figure 24.1). It can, theoretically at least, be taxed at 100% without affecting the investor's decision and without economic distortions, hence its advantage as a source of revenue for governments.

Figure 24.1. *Division of mining revenues between state and investors*



Mining taxation is distinct from general taxation because of the very nature of the economic activity concerned. The mining sector is characterised by two elements: particularly high and largely irreversible investment requirements – especially in the extraction phase – associated with the mining site itself, and multiple sources of uncertainty as to project profitability (operating costs, the price of the minerals extracted, etc.). The tradeoff referred to above is particularly salient for developing countries, which have neither the expertise nor the capital necessary to generate value from their underground resources. Finally, the definition of 'adequate' taxation of revenue or, in other words, an equitable share of rent is highly relative and even subjective, varying from one country to another and one period to another. The history of the oil industry, as described by Yergin (1991), and oil contracts linking multinational companies to state producers, is a key illustration of the change in the notion of equitable sharing of oil revenues during the twentieth century.

There is no optimal system for mining taxation applicable from one country to another. In fact, there is a wide variety of mining taxation systems, as shown in

Table 24.1. On the one hand, the very notion of 'optimal' is particularly difficult to establish. Extracting mining resources that are, by definition, non-renewable imposes a dynamic approach over periods that vary significantly from one mining project to another (from less than ten years for an average-sized gold mine to over half a century or even a century for so-called 'giant' projects). How much weight, then, should be allocated to future generations? On the other hand, even if it is specific to each project, mining taxation is part of the general tax system, at least in terms of the relationship between mining projects and the rest of the economy. Not only is a country's tax system the result of its history, but it also changes constantly.

A multitude of tax and tax-related instruments contribute to determining the share of mining revenues paid to the state. Some are specific to the mining sector, such as signing bonuses (though they are less frequent than in the case of oil contracts), land- and value-based royalties, state holdings granted free of charge or under other mechanisms, mining rent tax, and so on. Others are common to all formal businesses in the economy, even if their respective tax base or rates may differ from the ordinary system: corporation tax, import duties, value-added tax (VAT), employer social security contributions, tax on capital income (dividends and interest) and capital gains. These various payments rarely fall under the responsibility of a single administrative authority but generally several, which in turn are overseen by different ministries or agencies with greater or lesser degrees of autonomy (such as ministries of finance, ministries of mines, state agencies, etc.). This fragmentation of the tax situation reduces the coherence of the mining tax system and increases management costs for both the state and investors.

Whilst it may seem difficult or even illusory to establish optimal mining taxation, certain principles are necessary for ensuring an 'equitable' split of mining revenues. The first of these, which goes beyond the strict framework of mining taxation, is *transparency*. Without transparency, any discussions and attempts to improve a country's mining taxation are in vain, since specific mining agreements can escape tax and other obligations (e.g. requirements related to the environment or working conditions) governed by national laws. Measured against the yardstick of transparency, two other principles are essential for a developing country's tax system, namely its *simplicity* and its *neutrality*. These principles may reinforce each other but also run counter to each other, forcing the government to decide between them. A neutral tax system, for example, may be particularly complex to administer.

The first part of this chapter sets out the principles involved in discussing the qualities and failings of tax and tax-related instruments, which are examined in the second part.[2] The third part describes some of the mining taxation systems currently in effect in sub-Saharan Africa. The final part concludes this review of mining taxation.

2 There are numerous publications and articles examining taxation in the natural resources sector; see Daniel *et al.* (2010) for a general overview and Charlet *et al.* (2013) for a review of French-speaking African countries in particular.

1. The principles of an ‘optimal’ mining taxation system

Without transparency, mining taxation is ineffective at capturing some of the revenue from mining reserves. Unless they are made public, specific agreements can easily depart from tax legislation and provide particularly generous exemptions. Transparency in the extractive industries was put forward as a priority on the international stage by non-governmental organisations and several international institutions in the early 2000s. In 2003, for example, the World Bank launched the Extractive Industries Transparency Initiative (EITI). This aims to reconcile payments made by mining companies with revenues received by governments. By September 2014, 29 countries were classed as compliant, with 17 other candidate countries.

The EITI is part of a vast move towards strengthening financial governance, which extends beyond the strict framework of the extractive industries. Indeed, following the recent financial crisis, several developed countries that are home to multinational companies operating in this sector in particular have strengthened or are currently strengthening financial regulation. Although such laws, including the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States, aim primarily to protect shareholders and consumers, the disclosure of financial information they impose will help to form a clearer idea of the activity of multinationals in the countries in which they operate.[3]

Developing countries with high levels of natural resources have shown little active involvement in this shift towards greater transparency. Admittedly, several of them are now EITI compliant; however, they have not imposed allocation procedures or methods for managing their mining resources that are stricter than the standard set by the initiative, unlike developed countries with high levels of mineral resources, such as Canada or Australia. Systematic publication of mining contracts and agreements and feasibility studies would help improve transparency in the sector significantly. Although the former is one of the components of the EITI, publication of feasibility studies is rarely mentioned. These documents set out the technical and economic characteristics of mining projects and are generally essential for obtaining a mining permit. Publishing them is therefore a requirement for listed companies in Canada or Australia, in order to protect shareholders. Feasibility studies are in fact documents for which a company’s board of directors can be held accountable by their shareholders, for example, in the case of prosecution for manipulation of financial information.

For developing countries, transparency is not simply a means of reducing the information deficit between those in power and the people they govern, but also an industrial policy instrument that can be used to distinguish between multinational companies operating in their territory. Transparency can also operate as a self-selection tool, by filtering out the multinationals with the most

3 Note the recent decision by the US justice system, which ruled in favour of the Association of Petroleum Industries (API) and against an application under section 1504 of the Dodd Franck Act, which required the extractive industries to publish all the payments made by companies to the US and foreign governments. The decision was essentially motivated by the cost of submitting the information, which was deemed excessive by the private sector.

aggressive tax planning and other behaviours (in areas such as the environment and working conditions), since they are not subject to a strict disclosure policy in their country of origin (i.e. where their headquarters are located).

The principles of simplicity and neutrality are determining factors in the effectiveness of the tax system. As stated above, these may reinforce but also run counter to each other, forcing governments to decide between them. Simplicity is mainly associated with the implementation of the mining taxation system, i.e. its effective administration, whilst the principle of neutrality aims to extract a more or less significant share of mining rent without affecting the decision to invest. Whilst import duty on capital goods is easy to administer, for example, it increases the cost of production and can even act as a disincentive to investment. Conversely, whilst 100% taxation of mining rent is theoretically possible, it is particularly difficult to implement because of the difficulty of estimating such revenues.

The principle of simplicity aims to ensure adequate control of the main deductions of tax that make up the mining taxation system. Simplicity in the law also increases transparency. Furthermore, it improves the business climate by avoiding different interpretations by investors and the government concerned. Finally, it reduces the administration costs of the tax system, regardless of whether they are borne by the administrative authorities or by the businesses themselves (i.e. the costs of submitting tax returns).

An important means of simplification is the principle of 'ring-fencing', which limits mining or oil companies to one permit each. This restriction helps to limit the risks of offsetting and tax avoidance, in particular tax based on profits, between two mining or oil projects at different stages of operation. It becomes easier for the tax authorities to check the activities and taxable profits associated with each operating permit. Ring-fencing can even mean that the holder of an operating permit is not allowed to hold an exploration permit in addition to their current operating permit. Mining companies are therefore forced to create another legal entity to explore regions that are not covered by their operating permit. Finally, ring-fencing is also a way of combating the more widespread tax fraud found in any exemption scheme such as a mining taxation system. Exemptions from VAT or import duties are generally granted to holders of research or operating permits in the development phase, in order to reduce the cost of capital and attract foreign direct investment. Exemptions or rate reductions of this kind can lead to fraudulent behaviour by diverting imported goods from their initial intended use, namely mining exploration or operations.[4] Ring-fencing thus consists of excluding economic operators in other areas of activity from holding exploration or operating permits, or imposing the requirement to create a company dedicated to the activity that is correctly identified with the tax authorities.

The principle of simplicity also imposes rational organisation of the state administrative authorities concerned. For reasons associated with task

4 For example, a fuel distributor that holds an exploration permit may import petrol without paying duty or tax and resell it on the national market. A classic case involves building and civil engineering firms that hold quarrying permits that offer them a number of tax advantages.

specialisation or the history of the country, such services may be split between different ministries, such as the ministry of finance, the ministry of mines, the land registry, and so on. This fragmentation of services not only creates a duplication of costs for the state, but also means that multiple public officials are dealing with mining companies. Finally, it has a negative impact on transparency and good governance in the sector, exposing investors to contradictory public information.

The principle of neutrality is a guiding thread of any tax system, regardless of the area of activity concerned. It aims to generate tax receipts without affecting the behaviour of investors, savers or consumers.[5] Neutral taxation has no impact on the allocation of resources (which is assumed to be efficient or optimal). In the mining sector, and in non-renewable resources more generally, the principle of neutrality results in priority being given to taxes on mining rents or, failing this, the profits generated. Corporation tax, for example, is more neutral than proportional payments based on turnover, such as royalties.

A degree of progressiveness in the tax system applicable to natural resources may also be sought, in addition to the principle of neutrality. The division of mining revenues between the state and the investor varies according to the profitability of the mining or oil project. With a progressive system, the state's share increases as the profitability of the mining or oil project improves, and decreases as it declines. This offers a number of advantages: (i) it is automatic and therefore does not require any difficult renegotiations; (ii) it allows the state to take a larger share, particularly and normally when the world price of the resource concerned is increasing significantly; (iii) it reduces the risk for the investor by reducing tax pressure when the profitability of mining or oil operations is low; and (iv) by reducing the risk for the investor, it reduces the level of profitability it demands and increases taxable income. These advantages improve the stability of the tax system, which varies in a known and predictable way for both parties, and reduces risk for the investor.

A progressive tax system, however, assumes that the profitability assessment of a mining project is known and shared between the investor and the government. This is particularly difficult to establish and requires a tax administration system and legal framework that are able to capture aggressive tax optimisation planning. Finally, a progressive tax system also indicates that the state is willing to accept part of the risk of the investment. An optimal level of progressiveness therefore comes from a tradeoff similar to the choice made by any investor between expected gain (the share of rent paid to the state) and risk associated with this gain. Any tax regime will be more or less progressive, based on the tax instruments used.

2. Main tax and tax-related instruments in the mining sector

Table 24.1 shows mining taxation systems in a number of countries in sub-Saharan Africa. Mining firms are subject to taxes and other contributions under the general

5 Excise duties, on the other hand, are explicitly aimed at modifying consumer behaviour by increasing the price of certain goods whose consumption implies negative externalities (alcohol, tobacco, etc.).

tax system (columns 2, 3, 5, 6 and 8). This is supplemented by payments specific to the mining sector (columns 1 and 4) or adjustments to certain ordinary taxes (columns 2 and 3), such as signing bonuses, fixed and proportional royalties, mining rent tax, allocations of free equity of the mining company, and so on. Taxing the profits of the extractive industries, like taxing profits in other sectors, offers the advantage of relative neutrality but is particularly exposed to the risk of profit shifting (thin capitalisation, underestimation of turnover, transfer pricing, etc.). The remainder of this section examines specific taxation instruments used mainly during the operational phase. Except for a small number of taxes (such as signing bonuses or land royalties), most countries exempt exploration companies from any form of tax or import duty.

Proportional mining royalties (column 1) are a reliable source of revenue for the state from any mining project, as they are deducted from turnover or similar, regardless of the business' profitability. There are three advantages to this mechanism: (i) it is simple, and therefore easier to apply; (ii) it generates revenue from the first unit of resource extracted; and (iii) it is calculated on a stable and/or predictable base. Its main disadvantage is that it is regressive: the share of income paid to the state declines for the most profitable projects. Royalties also suffer from the disadvantage of increasing the marginal cost of mining projects and reducing the lifetime of certain new projects, in some cases making them non-viable. Because they are only paid during the production phase, royalties do not include the irrecoverable costs of exploring and developing mining reserves. They can therefore discourage exploration for high-risk projects.

The tax base used to calculate mining royalties varies significantly from one country to another. These royalties can apply to the volume and/or value of production. The latter can be the value of the resource when it is extracted from the mining project, the value of the processed product net of processing costs, or the value of exports net of transport and other costs. The same rate can therefore impose a different degree of tax burden, depending on the base. The rate of royalties is not necessarily flat. Some countries have royalty rates that vary in accordance with the quantities extracted, the price of minerals, or the profitability of each mine in order to make the tax system more progressive. The latter solution, which is applied in South Africa and Niger, is more difficult to implement than a royalty whose rate varies based on the internationally recognised price of the mineral concerned, as in the gold-mining sector in Burkina Faso.

The mining rent tax (MRT) described in Box 24.1 is based on the mining project's economic profit, i.e. the difference between the revenue generated by the activity and its economic and non-financial costs. In practice, the MRT is proportional to its discounted cash flow and applies as soon as the project achieves the level of profitability guaranteed to the investor. The MRT splits the risk between the state and the investor, whilst guaranteeing the return on investment set. It does not add to the marginal cost of production and is therefore neutral in terms of investment decision-making. Projects that would not be viable with a mining royalty can therefore become profitable based on an MRT.

No developing countries currently apply an MRT, although some – such as Guinea, Liberia and Sierra Leone – have introduced this type of mechanism into their mining legislation. Others, such as Liberia, have adopted a simplified form of the tax by taxing profits at a rate that varies based on the profitability of the business (column 7).[6]

Many states demand free equity of operating companies (column 4). This increases the immediate actual cost of investments without guaranteeing additional revenue for the state. In practice, such revenue is paid as dividends, which means the project must make a profit and dividend distributions must be approved by a majority of shareholders. The state, however, usually remains a minority shareholder and companies prefer to reserve their profits for funding other future mining projects, or repatriate them in a form other than dividends. Several developing countries have guarded against this risk by defining the concept of priority dividends.[7] The cost for the investor is immediate, automatically reducing the return on investment. State participation does, however, offer two advantages: (i) it responds to political demand by systematically associating the state with any project to extract renewable resources and can have a stabilising effect on the tax system with respect to public opinion; and (ii) it also allows better access to the financial information not only of the company that holds the permits but also of the investors who hold its remaining capital. This is not a negligible advantage when there is an indirect transfer of ownership of mining licenses and possible capital gains.

6 Amongst the major mining countries, Australia introduced a 'Mining Resources Rent Tax' (MRRT) in July 2012 but withdrew it in 2014. It related mainly to iron, coal and gas extraction projects, and the definition of the tax base was complex, based on mining profits. In spite of an MRRT of 30%, receipts were extremely disappointing compared with forecasts.

7 An alternative is to protect minority shareholders, whereby the state either limits the proportion of profits that can be set aside or imposes a minimum distribution of profits.

Table 24.1. *Mining tax systems in selected African countries*

	Royalty	Corporate income tax	Loss carry forward	Equity	Withholding Tax		Additional profit taxes	VAT	Import duties
					– Dividend	–Interest			
	1	2	3	4	5	6	7	8	
South Africa	Progressive royalties based on profitability of mine Min: 0.5% Max: 5% of adjusted revenues	0%-34%; variable rate depending on profitability of mine	Unlimited	Zero	15%	15%	None	14%	0%
Burkina Faso	Progressive royalties Min: 3% Max: 5% of turnover	17.5%	4 years		6.0%	6.0%	None	exempt	5% during exploration, exempt during development and 7.5% during production
Botswana	Min: 3% Max: 10% of turnover	Depending on level of profitability - min 22%	unlimited	Negotiable for diamonds; 15% for other minerals	15%	15%	None	12%	None
Democratic Republic of the Congo	Min: 0.5% Max: 4% of mine pithead value	30%	5 years	Zero	10%	0% (interest paid abroad)	None	Exempt	Exempt

	Royalty	Corporate income tax	Loss carry forward	Equity	Withholding Tax – Dividend	Withholding Tax –Interest	Additional profit taxes	VAT	Import duties
	1	2	3	4	5	6	7	8	
Ghana	5% of revenues (FOB price)	35%	5 years but excess capital allowances do not add to loss carryover, so in effect it is unlimited	10% free	8%	8%	None[2]	Exempt	Exempt
Guinea (MC 2011 - Amended)	Min: 0.075% Max: 5% of turnover (LME price for gold)	35%	3 years	Max 15% free + option for max 20% paid	10%	10%	None	Exempt	Exempt
Liberia	Min: 3% Max: 5% of revenues (FOB price)	30%	unlimited	Zero	5%	10%	20% tax on additional profits (deductible against corporation tax) after 22.5% with investment return	Exempt	Exempt before production, then 4% max in production
Mali (MC 2012)	3% ISCP on turnover + 3% based on mine pithead value[1]	25%	3 years	10% free + 10% option	10%	9%	None	Exempt for oil products, limited to 3 years for other products	Exempt for first 33 years of production

	Royalty	Corporate income tax	Loss carry forward	Equity	Withholding Tax – Dividend	–Interest	Additional profit taxes	VAT	Import duties
	1	2	3	4	5	6	7	8	
Mauritania (MC 2012)	Progressive royalties Min: 2.5% Max: 6.5% on turnover	25% and exemption for 3 years	Unlimited	10% free + 10% option	10%	Zero	None	14%	5%
Niger	Progressive royalties based on ratio of operating income/gross income Min: 5.5% Max: 12% on revenues (FOB price)	30%	Unlimited	10% free	10%	0%	None	Exempt	Exempt in pre-production then reduction of 65% during production
Senegal (MC 2012)	3% of mine pithead value +5% CSMC on turnover[3]	30% (with 40% tax credit for investment)	3 years	10% free	Zero (payments abroad)	Zero (payments abroad)	None	Exempt the first 15 years for major projects	
Tanzania	Min: 1% Max: 5 % On revenues (FOB price)	30%	Unlimited	10%	Zero	10%	None	Exempt	Exempt in pre-production then max 5%

Notes: The rates shown are those for the mining codes in effect and may differ from those actually applied in tax agreements.1) ISCP: Special Tax on Certain Products. 2) The 2012 budget introduced the application of a special tax of 10% on exceptional mining profits (not applied). 3) CSMC: Special Contribution on Mines and Quarries.

Source: Fiscal Analysis of Resource Industries (FARI) from the IMF Fiscal Affairs Department.

Box 24.1. *Different forms of mining rent tax*

Brown tax: This tax is calculated on the basis of the project's cash flow. The basis for the tax is therefore made up of all revenue from sales of the resources minus all capital and operational expenditure. No interest or other financial charges are deducted, since investment expenditure is immediately subtracted from revenue. In the period where cash flow is negative, typically during the development phase, the state pays the investor a cash rebate equal to the tax on losses. In the period where cash flow is positive, during the production phase, the state receives a fixed share of revenues.

MRT: This is similar to the Brown tax but the deficit is carried over to subsequent years. The MRT is used when the government does not want to reimburse the investor during periods of negative cash flow. The tax is therefore only paid once the investor achieves a minimum level of profitability.

Variable rate of tax on profits: This tax is based on the principle of corporate income tax (CIT), but its rate varies depending on changes in the profitability of the project (for example, based on a profit ratio in relation to the gross income generated by the activity). This system is applied in South Africa, amongst others.

Additional tax on cash flow: The accounting basis for tax on profits is adjusted by adding provisions for depreciation and interest on capital and deducting capital expenditure over the course of the financial year. This is the system used in the oil industry in the UK.

3. Current tax regimes

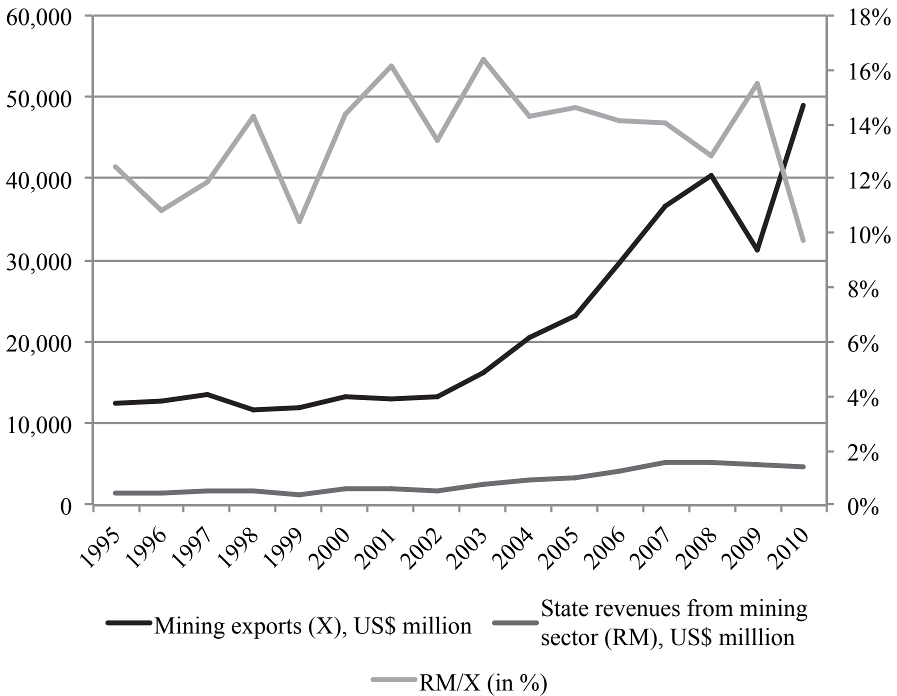
Although numerous developing countries with high levels of mining resources have recently reviewed their tax legislation, thus improving its neutrality, the effects in terms of receipts for the governments concerned are not immediate. Indeed, most countries have provisions for tax stability that protect investors against any risk of changes to the main taxes that may be to their disadvantage.[8] Provisions of this kind were first introduced in Latin America in the 1920s (Yergin, 1991) and are designed to protect investors against the risk of expropriation implied by amendments to tax laws. They naturally result in a degree of inertia in the response of tax revenue to world prices for minerals and the value of exports. Such provisions can even result in a general renegotiation of mining contracts, as in Guinea, for example, thus deviating from their initial objective.

Figure 24.2 illustrates some failures of current mining tax regimes in countries in sub-Saharan Africa with high levels of mining resources. It shows the change in state revenue from the mining sector and in mining exports for a small number of African countries. Mining tax revenue represented around 12% of the value

8 Such provisions can even be asymmetrical, allowing investors to opt for any more generous tax provisions without losing the benefits of their initial tax regime. It is thus common to see that the decrease in statutory rates of CIT since the 1990s has enabled mining companies to reduce CIT they are required to pay but without having to abandon CIT holidays generally granted during the project's first few years of existence.

of exports in 1995 and less than 10% in 2010. Taking the variation in exports – with all the appropriate caveats – as a very approximate indicator of the variation in mining revenues,[9] the share paid to the state has deteriorated significantly. The lack of progressiveness in tax systems is one of the main reasons why the recent upsurge in world prices for commodities in general, and minerals in particular, has not been accompanied by a similar increase in receipts for exporting countries.

Figure 24.2. *Government revenues from the mining sector and mining exports for some African countries, 1995 to 2010 (current US dollars)*



Notes: The following countries were included: South Africa, Botswana, Ivory Coast, Guinea, Mali, Namibia, Niger, Central African Republic, Togo and Zambia.

Sources: Mansour (2014) for the value of government receipts and CNUCED for the value of exports for the countries concerned.

International taxation also has a significant impact on the sharing of mining revenues, and therefore the application and definition of 'optimal' mining taxation. Indeed, most countries have ratified some double taxation agreements (DTAs). These treaties generally follow the OECD model, which splits the power to tax international transactions between two states. Their initial intention was to encourage foreign direct investment by avoiding double taxation of dividends,

9 The variation in extraction costs has not been taken into account, significantly influencing the scope of our analysis.

in particular. Such treaties can, however, significantly limit the tax powers of developing countries and encourage transfers of large amounts of income to tax havens.[10] For example, the revocation of the DTA between Mongolia and the Netherlands, instigated by Mongolia, was motivated by a substantial loss of tax revenue from the mining sector. The Netherlands has since undertaken a review of its DTAs with several developing countries, which might be prejudicial to public finances of the latter. Increasing doubts are being raised not only over DTAs but also bilateral investment treaties, as a source of international arbitration and lawsuits (van Os and Knottnerus, 2011).

As well as looking for 'optimal' mining taxation, states want to improve their general taxation, which plays a dominant role not only in establishing an 'equitable' division of mining revenues but also in ensuring that mining activities contribute to the country's economic development. For instance, thin capitalisation rules first introduced in Canada in 1972 generally fall under standard tax law. They aim to limit profit-shifting that multinationals, whether or not they operate in the mining sector, can realise through internal debt mechanisms.[11] In addition to protecting the CIT base, Arezki *et al.* (2014) establish that such rules support the development of the financial sector in countries that are rich in natural resources and reduce the outflow of capital. Another example concerns VAT and its role in formalising the economy of developing countries, which can be significantly strengthened or damaged depending on whether mining companies are liable to VAT or exempt from it (see Box 24.2).

4. Conclusion

Mining taxation is the result of the tradeoff between attracting the international investors needed to drive mining revenue and ensuring that such revenue is 'adequately' taxed. This is reflected partly in the institutional fragmentation in countries between different administrations, agencies and ministries, which reduces the consistency and efficiency of mining taxation. The latter combines both tax payments governed by tax legislation and tax-related deductions governed by mining codes or specific regulations.

Optimal mining taxation appears to be difficult or even impossible to establish. Certain principles are set out in this chapter, however, aimed at ensuring an 'equitable' sharing of mining revenues and avoiding the 'curse of natural resources'. Transparency appears to be an essential prerequisite for any discussion of mining taxation. The other two principles are simplicity and neutrality. Typically, value-based royalties are combined with corporation tax to make up the main receipts based on mining revenues. Numerous other mechanisms are available, such as mining rent tax or free equity.

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10 DTAs relate primarily to dividends, interests, royalties and capital gains.

11 Internal debt allows part of the profits from a subsidiary that holds a mining permit in a resource-rich country with a high level of natural resources to be transferred to a subsidiary based in a tax haven where financial income is not taxed. The first subsidiary, which will be undercapitalised, takes out a loan from the latter. This loan entails payment of interest charges that are deductible from corporation tax, which become non-taxable financial income for the subsidiary granting the loan.

Box 24.2. *VAT liability in the mining sector and formalisation of the economy*

Mining companies are exporters and are therefore zero-rated, which entitles them to a reimbursement of the VAT they pay on their inputs. Such requests for reimbursement often create difficulties both in terms of cash flow for states with fragile public finances and in administrative terms. Given these difficulties, mining companies request and generally obtain a VAT exemption, which does not, in principle, result in any loss of revenue for the state, since VAT is a tax on domestic consumption.

Exempting a small number of mining companies from VAT does not, however, resolve the problem of requests for reimbursements of VAT credits, but actually worsens it by transferring the position of net VAT creditor to the multitude of suppliers who provide goods and services to a few mining companies. VAT exemption is therefore generally extended to the entire sector, i.e. to the extraction companies' subcontractors and suppliers.

One of the principal characteristics of VAT in developing countries, however, is not so much its neutrality as its credit/debit mechanism, which consists of delegating to the private sector the disclosure of information on the activities of suppliers and customers, and ultimately results in a formalisation of the economy. Indeed, a mining company that is subject to VAT and wants to obtain reimbursement of the VAT paid on its inputs has an incentive only to select suppliers properly registered with the tax administration, since unregistered suppliers will not be able to provide them with proper invoices. By examining requests for VAT credit reimbursement, the tax authorities gain access to a significant amount of information on suppliers' activities, which is particularly useful for the payment of their direct taxes (CIT and others).

Mining taxation therefore remains intrinsically linked to general tax laws that apply to a country's formal economy. The fact that it is only moderately effective (see Figure 24.2) can be explained by its limited degree of progressiveness and by the vulnerability of general tax laws in light of aggressive tax optimisation planning (transfer pricing, thin capitalisation, indirect transfers of mining licenses, etc.). This vulnerability is all the more significant as double-taxation agreement networks generally allow a transfer of profits to tax havens. Finally, in addition to their direct contributions to the national budget, mining companies can play an active role in a country's financial development or the formalisation of the economy, provided they are correctly capitalised or liable to VAT. These conditions are rarely fulfilled in developing countries.

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25

Innovative Financing for Development

Philippe Douste-Blazy and Robert Filipp

1. Introduction

The concept of innovative financing for development – mechanisms outside the traditional ambit of official development assistance (ODA) that generate additional, sustainable and predictable revenues for development – was first introduced at the International Conference on Financing for Development in Monterrey, Mexico in 2002.

Since 2002, in the context of financing the Millennium Development Goals (MDGs), a handful of innovative financing mechanisms have been successfully implemented, providing US$7.87 billion in additional funding to date. They include mechanisms such as the vaccine bond and the air ticket solidarity levy. To date, all the mechanisms have been about global health financing – in particular, immunisations against a number of diseases and treatments for HIV/AIDS, tuberculosis, malaria and, more recently, hepatitis – working through global public-private partnerships such as the Global Alliance for Vaccines and Immunization (Gavi) and UNITAID.

The impact of innovative financing for development is not limited to money only. By virtue of its design, its unique stakeholders and networks, innovative financing stimulates innovation in the use of the resources it generates. The virtuous circle between innovative funding and innovative spending often results in new impact. The Medicine Patent Pool (MPP), funded by UNITAID, is one such example. Pharmaceutical companies participating in the MPP make available their patents for drugs and are compensated by the pool, in effect putting in place a regulated regime for price reductions and availability of the latest drugs in the poorest countries. Reduced medicine prices, agreements to produce medicines – for example, for HIV/AIDS – for children and which are predominately required in poorer countries, and predictable prices for vaccines are all examples of impact that ultimately saves lives.

In the future, innovative financing will become even more important as a source of additional, predictable and sustainable funding for development and innovation, especially the post-2015 Sustainable Development Goals (SDGs). There are two good reasons for this. The first reason has to do with the challenges faced by industrialised countries. In many OECD countries, public finances are in disarray because of heavy debt and slow economic growth. Priorities such as structural reforms, banking reforms, the euro, job creation (especially for youths) and the fight against terror are bound to affect ODA. The second reason

has to do with emerging economies and developing countries. There have been remarkable shifts in the global economy in how wealth is generated, where it is generated and how it is distributed.

In many countries, the middle class is growing and this is likely to affect the way traditional development aid is viewed. But the most worrying trend is the disparity in the accumulation of wealth. In 2014, the richest 1% of individuals in the world owned 48% of global wealth, leaving just 52% to be shared between the 99% of adults on the planet.[1] Of this 52% of global wealth, almost all is owned by the richest 20% on the planet, leaving just 5.5% to be distributed among the remaining 80% of the people on the planet.[2] In January 2014, Oxfam calculated that in 2013, 85 people had the same wealth as the bottom half of the world's population (Fuentes-Nieva and Galasso, 2014).

Against this backdrop, innovative financing for development can take its rightful place in the aid architecture because it is derived directly from the revenue streams and repositories of capital that characterise the twenty-first century. Innovative financing can harness the power of the new global economy and, especially, financial innovation to meet the need of the poorest people on our planet. Some 2 billion people – 75% of whom are under the age of 20 – still have to contend with next to nothing. Unless we address the significant economic and social divides through massive investment in education, health, jobs, sanitation, climate safety and so on, we will have to contend with extremism, terrorism and mass migration.

While no panacea for social infrastructure financing, innovative financing for development is a creative solution for development finance that is in tune with the realities of the twenty-first century. It is not a call to end capitalism, but an attempt to make capitalism work for all. The world urgently needs new ideas to meet its social, development and demographic challenges.

2. Experience to date

In 2002, when innovative financing for development was first introduced within the context of financing the MDGs, no clear definition was provided with the consequence that the term has been used freely to describe a large number of initiatives. The Brookings Institution once mapped more than 90 examples of financing initiatives classified as 'innovative' in the health sector alone.[3] While there may be many innovative financing initiatives, these should be distinguished from the relatively few innovative financing activities that are actually generating revenues and conform to the widely accepted definition of 'innovative financing' as mechanisms outside the traditional ambit of ODA, that generate additional, sustainable and predictable revenues for development.

Since 2002, the only substantial innovative financing activities have been a handful of mechanisms in the health sector (see Table 25.1). Broadly, they can be divided into three categories:

1 Oxfam (2015).
2 Ibid.
3 Glassman *et al.* (2008).

- solidarity levies;
- debt securitisation and debt swaps; and
- market incentives.

Table 25.1. *Major innovative financing activities to date*

Type	Initiative	Description	US$ bn	Organisation
Solidarity levies	Air ticket levy	Surcharge on air tickets ranging from €1-40 in 13 participating countries used to reduce drug prices and provide latest treatments for AIDS, tuberculosis, malaria and hepatitis	2.5 (1.3) ↑	UNITAID
	Extractive industries micro-levy	Surcharge on sale of oil, gas, mining in participating countries in Africa to finance efforts to combat chronic malnutrition and stunting	New ↑	UNITLIFE
Debt securitisation/ debt swaps	Vaccine Bond	Long-term pledges to the International Finance Facility for Immunization (IFFIm), which are securitised for bond issues in the capital markets	3.7 →	Gavi
	Debt2Health	Swaps sovereign debt against cash payment towards programs of the Global Fund	0.17 ↓	Global Fund
Market incentives	Advance market commitment (AMC)	Mechanism that makes up-front funds available to incentivise R&D and production of certain vaccines in exchange for preferential prices	1.5 →	Gavi
Total			*7.87*	

Source: Innovative Finance Foundation (2015).

The majority of innovative financing mechanisms for development rely on public policy and regulation in the form of levies, government pledges for debt contract securitisation, and sovereign debt swaps to generate new funding. All the mechanisms have been in support of the newer types of public-private partnerships such as UNITAID, Gavi or the Global Fund to Fight AIDS, Tuberculosis and Malaria.

Innovative financing has played an important role in stimulating innovation in how aid is spent. Often, stakeholders engaged in innovative financing – whether funders or recipients – demand a distinct value added of innovative financing to the development landscape. This virtuous circle between innovative funding and innovative spending often results in entirely new impact on the ground. Gavi, the Global Fund and UNITAID have all deployed innovative disbursement

models such as results-based funding, but one example illustrates the impact of innovative financing in terms of innovation in spending innovative financing revenues particularly well. The Medicines Patent Pool (MPP) is a voluntary mechanism created by UNITAID designed to make the latest R&D from companies such as Gilead, Roche and ViiV (Pfizer and Glaxo) legally available to generic producers so that the latest drugs can be available in poorer countries at the same time as in the industrialised countries. Through the MPP, the latest drugs can be made legally available at more affordable prices. For example, treating a patient for one year with the most affordable improved first-line regimen for HIV, as recommended by the World Health Organization (WHO), costs between US$613 and US$1,033 using originator products. This represents at least an eight-fold increase from the price of the older regimen of US$87.

2.1. Solidarity levies

The airline ticket levy and UNITAID

Global taxation as an instrument of finance development aid has a long and controversial history. In the area of innovative financing for development, a breakthrough came with the introduction of the air ticket solidarity levy to fund global health via UNITAID in 2006.

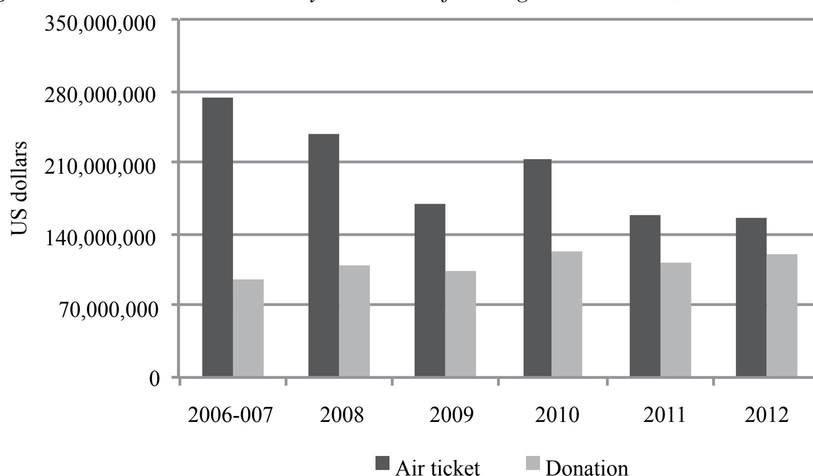
The air ticket levy ranges from €1 to €40 and is collected in participating countries (Cameroon, Chile, Republic of Congo, France, Madagascar, Mali, Mauritius, Morocco, Niger and the Republic of Korea). The most significant share – about €350 million per year – comes from France, where fliers are charged €1 for domestic/intra-EU economy class tickets, €4 for international economy, €10 for domestic/intra-EU first and business class, and €40 for international first and business class. In January 2013, France announced that the tax had collected €1 billion since its inception in 2006. Initial concerns that the levy might cause a reduction in volumes of passengers to participating countries proved to be entirely unfounded, thanks to the small size of the levy.

To date, the airline ticket levy has raised US$1.3 billion for UNITAID, an independent financing organisation administered by the WHO. The objective of UNITAID is to ensure that the latest treatments and diagnostics tools for HIV/AIDS, tuberculosis, malaria and hepatitis are available in the poorest countries, because it is unacceptable that a patient in Bamako or Addis Ababa has to wait between 15 and 20 years for medicine that is readily available in London or New York. UNITAID works with manufacturers in areas such as AIDS medicines for children, second-line treatment for tuberculosis – the only effective way to combat the disease in the event of resistance against the most commonly used drugs – and anti-malaria treatments. It also finances the rollout of treatments through partners on the ground, including the Clinton Health Access Initiative (CHAI), Médecins Sans Frontières, The Global Fund to Fight AIDS, Tuberculosis and Malaria, Roll Back Malaria, and UNICEF, amongst others.

In addition to revenue from the air ticket levy, UNITAID receives voluntary contributions from donors and private foundations including Norway, the United

Kingdom and the Bill and Melinda Gates Foundation. Altogether, UNITAID has received US$2.5 billion since 2006 (Figure 25.1). UNITAID has been able to double the funding that the air ticket levy generates through other government and private contributions, hence the leverage effect has been 100%, which is virtually unprecedented in international development finance.

Figure 25.1. *Airline ticket levy and other funding to UNITAID, 2006-2012*



Source: UNITAID, Innovative Finance Foundation (2014).

The impact of the air ticket levy has been significant. UNITAID has accelerated the time to market of products required for populations in Africa, such as AIDS medicines for children. Through the Medicines Patent Pool, UNITAID has also transformed the pricing of the latest effective medicines and diagnostic tools. This includes reducing the price of HIV/AIDS drugs for children and adults by 80% and 60%, respectively; reducing the price of a new drug against malaria based on *artemisin* by 85%; and reducing the price of tuberculosis tests by 40%. Today, UNITAID finances eight out of ten children treated for AIDS, totalling over 700,000 treatments. In addition, UNITAID pays for HIV testing for 2 million infants and 8 million pregnant women, 350 million anti-malaria treatments and 2 million tuberculosis treatments.

The extractive industries levy and UNITLIFE

Regions with substantial natural resources and wealth from extractive industries can and must play a role in innovative financing for development. Extractive industries include the use of the earth's non-renewable resources, ranging from oil exploration to mining. While this definition is focused on non-renewable resources, a case can be made for including water, forest products and other resources in the definition, especially when the scale and speed of exploitation endangers the long-term sustainability of such resources.

Africa has more than 15% of the world's oil reserves, 40% of its gold reserves and large reserves of other metals and rare earths. Nearly a quarter of Africa's GDP is now based on extractive industries, the highest ratio among all regions. Between 2000 and 2008 alone, the value created from natural resources in Africa rose from US$39 billion to US$240 billion. There is considerable debate over how best to deploy natural resource revenues. The most accepted model involves the creation of a sovereign wealth fund (SWF) with the primary aim of preserving and investing excess revenues for future generations, thereby avoiding short-term pitfalls such as Dutch disease[4] and wasteful expenditure.

The Innovative Finance Foundation has proposed an *endowment approach* whereby natural resources are looked upon as a pool of wealth for future generations and a small portion is deployed *immediately* to build public services to ensure that the next generation does, indeed, benefit from this wealth.[5] If children are not adequately nourished and educated, they cannot reach their full potential, rendering the prospect of future wealth meaningless.

The extractive industries micro-levy is a way to advance a portion of investment in social infrastructure to the present by targeting one of the major challenges on the African continent: chronic malnutrition resulting in stunting. Chronic malnutrition remains the leading risk factor for death and disability among children. The long-term impact – known as stunting – on the human capital of these countries is profound. Children who lack essential nutrients in their diets during the critical growth period never reach their full potential in terms of height, educational achievement and long-term productivity. In Africa, the countries producing the most oil have the highest number of stunted children. Globally, one quarter of children under the age of five, or a total of 162 million children, suffer from stunting.

The Republic of Congo is the first country to implement the extractive industries micro-levy of US$0.10 for each barrel sold by the state oil companies. If eight select African countries were to implement the extractive industries micro-levy, the mechanism would generate US$194.5 million annually if the entire oil production were included, and US$97.25 million annually if only half of the oil sales assumed to be under the direct control of the state were counted (see Table 25.2). If all the oil-producing countries of the world implemented a micro-levy of 10 cents, and assuming that only half the oil sales were counted, the mechanism would generate US$1.64 billion annually.[6]

Despite the magnitude of chronic malnutrition resulting in stunting, global funding available today for tackling stunting is paltry, and is dwarfed by the money available for HIV/AIDS (which is up to 50 times greater). If implemented in just seven African countries simultaneously, the micro-levy would generate

4 The negative impact of natural resource export revenues on local manufacturing and agricultural sectors.

5 Innovative Finance Foundation (2014).

6 Ibid.

sufficient funding to potentially eliminate stunting in Angola, Cameroon, Chad, the Republic of Congo, Equatorial Guinea and Gabon by 2020.[7]

Table 25.2. *The 10 cents levy on a barrel of oil in Africa*

Country	Oil production (2013) in bbls/ day	10 cents levy (0.001%)	Revenue scenario (50%)
Angola	1,889,000	68,948,500	34,474,250
Cameroon	63,000	2,299,500	1,149,750
Chad	98,000	3,577,000	1,788,500
Congo (Republic of)	279,000	10,183,500	5,091,750
Equatorial Guinea	291,000	10,621,500	5,310,750
Gabon	239,000	8,723,500	4,361,750
Ghana	99,000	3,613,500	1,806,750
Nigeria	2,371,000	86,541,500	43,270,750
Total		*194,508,500*	*97,254,250*

Source: USEIA, Innovative Finance Foundation (2014).

Building on the successful model of UNITAID, the extractive industries micro-levy will be managed by a new financing organisation called UNITLIFE. UNITLIFE will received the levy revenues and leverage them with other government and private sector contributions to finance evidence-based solutions for chronic malnutrition and stunting. These solutions include breastfeeding, intake of vitamins and minerals, adequate complementary and therapeutic feeding with specialised foods, and assured access to health services and sanitary environments. Implementing partners on the ground may include Action Contre La Faim, the African Union, the Bill and Melinda Gates Foundation, the Children's Investment Fund Foundation (CIFF), the Clinton Foundation, the Global Alliance for Improved Nutrition (GAIN), Helen Keller International, Médecins Sans Frontières, Scaling-Up Nutrition (SUN), UNICEF, the World Food Programme (WFP), WHO and civil society organisations, in particular from Africa and Asia.

While it is too early to speculate about the precise impact of the innovative financing approach on distributive justice for natural resource wealth, it is certain that the participation of countries in the extractive industries micro-levy and in a global initiative to fight chronic malnutrition (improving the lives of millions with a ring-fenced, direct contribution from the extractive industries to an international entity backed by the United Nations) is a 'game changer' in this area and in development finance.

2.2. Debt securitisation and debt swaps

Vaccine bonds and the IFFIm

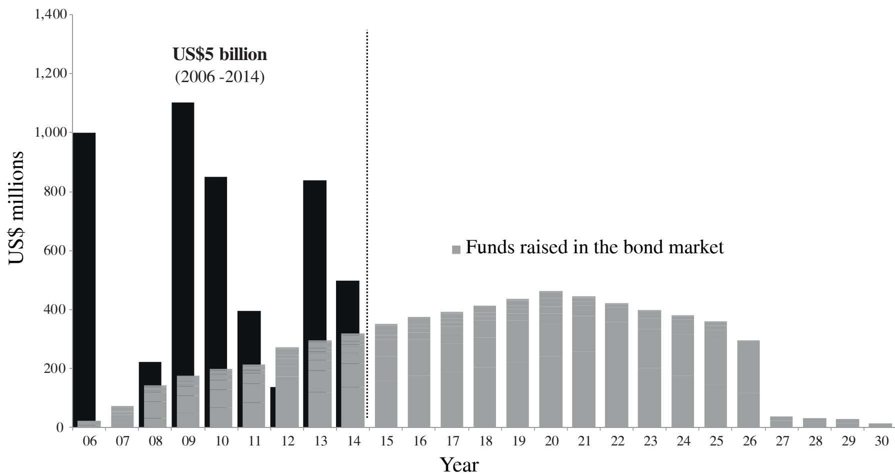
Securitisation is the financial practice of pooling contractual debt and selling it in smaller tranches to investors as bonds. A bond is an investment in a debt

7 Innovative Finance Foundation (2014).

whereby the investor receives a fixed return on the principal and interest of the underlying security. The key determinants of a bond's interest rate are the credit quality (credit rating) of the borrower and the duration of the loan. Debt issuance for social purposes and development has been part of the bond market for many years, largely driven by the need for funding in areas such as water, sanitation, climate and health.

The game-changing innovative financing mechanism in this space is the vaccine bond issued by the International Finance Facility for Immunization (IFFIm). Under this structure, governments provide long-term, contractually binding pledges to a special purpose vehicle, the IFFIm, which in return securitised this debt for a bond issue in the capital market. Launched in 2006 by the UK government, the IFFIm has received pledges of US$6.3 billion over a 23-year period. To date, the IFFIm has issued bonds worth US$3.7 billion. Funds raised by the IFFIm bonds are earmarked for Gavi, a public-private partnership that reduces the number of vaccine-preventable deaths and illness among children under five. The underlying rationale for the vaccine bond is that aid can be 'frontloaded' via the vaccine bond, where financing a scale-up in vaccinations in the present will reap tangible benefits in terms of lives saved and health system savings in the longer term.

Figure 25.2. *Vaccine bond economics*



Source: World Bank, downloaded from http://www.iffim.org/donors/.

Debt swaps

Debt swaps, or debt conversions, were first conceived by Thomas Lovejoy of the World Wildlife Fund (WWF) in 1984 as a strategy to deal with the problems of developing nation indebtedness and the associated negative effects on the environment. Debt-for-nature agreements have generated over US$1 billion for conservation in developing countries, but in recent years the volume of debt-

for-nature swaps has declined, partly because conservation organisations could purchase relatively large debt obligations on the secondary market at highly discounted rates, and partly because of large global debt restructuring and cancellation agreements, such as the Heavily Indebted Poor Countries (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI). Debt conversions in other sectors enjoyed popularity throughout the 1990s and are still used today by several creditor donors as an instrument of development policy.

Typically, debt swaps for development are bilateral agreements between a creditor and debtor whereby the creditor agrees to cancel an agreed amount of debt on the condition that the debtor spends an agreed amount (counterpart funds) for development or social purposes. Generally, creditors have the option to offer discounts on the counterpart funds to be paid for the debt. In most cases, a special counterpart fund is created to manage the disbursement process. The aim of debt swaps is to allow a debtor country to use freed-up fiscal space – created through savings on interest and a reduced principal – for development and social purposes. An additional benefit of debt swaps is that the counterpart funds can be in local currency.

In 2007, the Global Fund pioneered a debt conversion programme, Debt2Health, as an innovative financing mechanism for health. The programme works like a bilateral debt conversion, but entails a cash payment of the counterpart funds to the Global Fund, which is earmarked for approved health programmes in the debtor country. This assures impact and performance-based management of the counterpart funds. The programme has converted US$300 million in sovereign debt from Germany and Australia into US$170 million in new cash for Global Fund health programmes in Indonesia, Pakistan and Ecuador.

2.3. Market incentives

Advance market Commitment

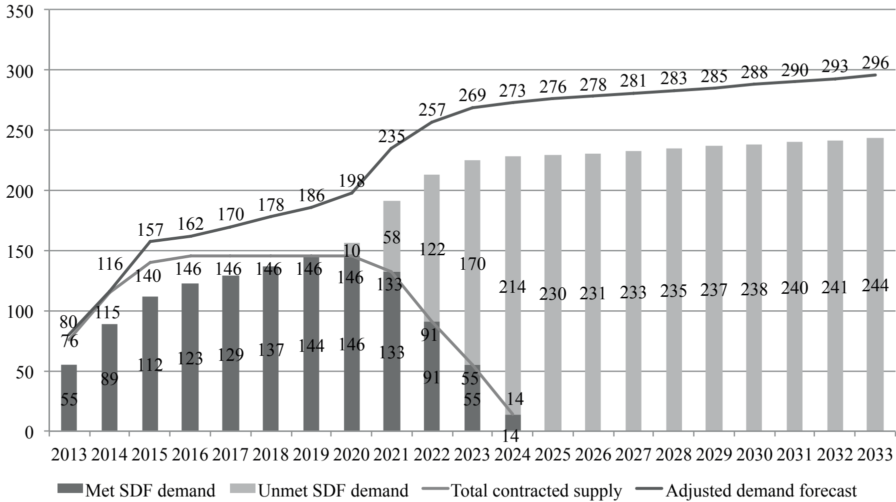
Advance market commitments (AMCs) are a contract mechanism used by Gavi that incentivises R&D and the production of new vaccines by guaranteeing a viable market for products. Italy initiated an AMC in February 2007 for a new pneumococcal vaccine, and Canada, Russia, Norway, the UK, and the Bill & Melinda Gates Foundation pledged US$1.5 billion to the AMC mechanism. Pneumococcal disease is caused by bacteria and can lead to serious infections in the lungs (including pneumonia), blood and brain. In 2005, WHO estimated that the disease was killing about 1.6 million children every year, of which between 7,00,000 and one million were under the age of five. The majority of these deaths were in developing countries.

Under the AMC for the new pneumococcal vaccine, Gavi commits to buying or subsidising the purchase of a fixed quantity of vaccines at a given price, and suppliers commit to offering the vaccine at a lower price after the subsidy ends.

In the period 2010-2012, the two AMC-eligible pneumococcal vaccines are a 10-valent produced by GlaxoSmithKline (GSK) and a 13-valent manufactured

by Pfizer. In terms of supply, during the period 2010 to 2012, a total of 101 million doses have been procured and delivered.

Figure 25.3. *Strategic demand forecast for pneumococcal vaccines*



Source: Gavi Pneumococcal AMC Annual Report 2014, downloaded from http://www.gavi.org/funding/pneumococcal-amc/.

3. The role of the private sector

There have been a good number of innovations in the field of development finance, including microfinance, social impact investing, pay-for-performance mechanisms, matching funds, blended instruments, and various insurance schemes and consumer marketing programmes. While all these make contributions to fighting poverty, creating social infrastructure and development, they have not been considered as falling under the ambit of innovative financing for development. One of the reasons might be that these innovations do not always generate a clearly quantifiable revenue stream that is additional, predictable and sustainable. Another reason might be that many private-sector activities are undertaken outside the traditional development aid networks.

Although innovative financing depends on private activity – for example, the airline ticket levy is based on private air travel and the vaccine bond is based on investments made by private investors – to date, the innovative financing for development has been in initiatives driven by the public sector – government and civil society – that generate a identified revenue stream that is invested in development.

The role of private business in innovative financing for development is only just emerging, with the Medicines Patent Pool providing one example of how an existing innovative financing revenue stream incentivises private companies to create a new impact. The MPP is a voluntary mechanism created with funding

from the air ticket levy and UNITAID designed to make patents from companies such as Gilead, Roche and ViiV (Pfizer and Glaxo) legally available to generic producers and to compensate the patent holders.

A financial transaction tax (FTT) holds the promise to engage the private sector in innovative financing for development and impact innovation. The global capital markets – estimated at US$212 trillion[8] – are also a largely untapped potential source for financial innovation and financial engineering to fund social infrastructure and development. Growth in the emerging and frontier markets also offers unprecedented opportunities for financial innovation. In developing countries, assets worth more than US$6 trillion are held by pension funds, insurance companies, mutual funds, and so on, and these assets are growing by 15% per year.

An untapped opportunity exists to work with the financial markets to 'do good while investing well'. The deployment of attractive innovative finance offerings for the global financial markets, while no panacea for development financing, at least offers an opportunity to engage with a wider range of potential supporters and constructively contribute to the development of sustainable, robust and long-term funding solutions for social infrastructure and development. There are numerous other excellent opportunities, but they require of development organisations more of a 'stretch' in terms of expertise, partnerships and risk. The challenge is to formulate approaches and models that are capable of attracting a larger portion of assets into development finance and to generate additional, sustainable and predictable revenue streams.

3.1. Impact investing

Impact investing, or value-based investing, is a 'sector' that garners attention among organisations interested in innovative financing for development. The number of funds engaged in impact investing has grown quickly and the impact investing industry will increase from its present US$50 billion in assets to US$500 billion within the next decade.[9] However, there is perhaps some 'excessive exuberance' in the impact investment space partially fuelled by the appetites of multilateral financing organisations and charitable foundations.

Impact investing is an investment approach that uses a wide range of commercial capital deployment tools – such as equity, debt, working capital lines of credit, and loan guarantees – to create measurable social value. The theory indicates that impact investors are prepared to put social impact over financial return. Even if the theory is not always adhered to and investors are looking for a reasonable financial return along side social value creation, impact investing in certain asset classes (the environment, climate, vaccine development, etc.) could well fall under innovative financing for development, but would probably require ways to better reconcile social impact goals with financial return goals, finding the appropriate equilibrium between access and social equity and financial palatability.

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8 Roxburgh *et al*. (2011).

9 Monitor (2009).

Impact investing is distinct from socially responsible investing (SRI), which generally refers to an investment approach that aims to minimise the negative societal impacts of investments by applying so-called negative screens (concerning, for example, alcohol, tobacco, gambling, pornography or the military) to investment decisions.

Recently, 'blended instruments' have also been proposed as a way to address social infrastructure and development challenges. Blended instruments describe an approach that uses financial engineering with the aim of leveraging different types of capital – such as grants, loans, and various forms of private investment (impact, private equity, etc.) – to achieve the widest possible scale, diversification and risk adjustment. One example is a 'megafund' that has been promoted to raise money for a portfolio of cancer drug development projects, thereby mitigating risk and offering a range of risk/return profiles to meet individual investor needs (Fernandez *et al.*, 2012).

3.2. Private capital as guarantor

Development or social impact bonds (DIBs or SIBs) are a good example of private capital as guarantor. Strictly speaking, these are not bonds, but pay-for-success loans or contracts. The key element are investors who advance money to a promoter (usually a public sector entity) to finance a promising but unproven social or developmental intervention on the condition that, should the specified benchmarks/social impact be achieved, investors are paid out the principal invested, and possibly a financial return. The dominant feature of social impact bonds is risk and reward sharing, an element absent in the vaccine bond. While social impact bonds operate over a fixed period of time, they differ from normal bonds in that they do not offer a fixed rate of return and cannot be traded.

The development or social impact bond 'sector' is still very young, and owes much of the attention it garners to the work of the UK-based organisation Social Finance, which pioneered the methodology and implemented the first project in 2010. This project raised £5 million for a counselling service targeting a reduction of re-offending rates among short-term prisoners in Peterborough, UK and offered a 13% expected return in case of success within an 8-year timeline. The strong community development aspect of development impact bonds offers an opportunity to leverage domestic business and local philanthropy for investment, but it remains to be seen whether the mechanism can be scaled up to national or global social infrastructure and development needs, thereby generating co-financing for bilateral or multilateral assistance or providing performance-based funding for transition or graduation from multilateral funding.

3.3. Social marketing

Social marketing and cause-related branding is a vast area. Some programmes could well be considered innovative financing for development, but the challenge is to understand the universe of social marketing and to apply consistent criteria to the space in relation to innovative financing (additional, sustainable and predictable revenue streams for development).

Cause-related marketing is often an integral part of a corporate social responsibility (CSR) strategy, an example being the donation programmes of airlines, hotel companies, and so on. Independent cause marketing operations such as PRODUCT (Red)© stand out for their scope and scale. PRODUCT (RED)© member companies, which include some of the best known brands around the world, create special lines of products and donate a portion of their profits – some US$250 million to date – to the fight against AIDS in Africa via the Global Fund to Fight AIDS, Tuberculosis and Malaria.

An interesting example of potential private sector innovative financing is the Dow Jones Global Fund Index pioneered by Dow Jones Indexes and the Global Fund to Fight AIDS, Tuberculosis and Malaria in 2011. The index included 50 Fortune 500 companies that supported the Global Fund to structure an exchange trade fund (ETF) that would then be offered to investors. The financial institution that was selling the ETF would donate a part of their fees, and investors a part of their profits (if they chose to do so), to fund health programmes of the Global Fund. Although Deutsche Bank undertook steps to champion this novel idea, the mechanism never took off due to a lack of conviction and capacity in what is principally a well-financed grant-making organisation to carry the project to fruition.

While it is nearly impossible to categorise the entire universe of social marketing in relation to innovative financing, it might be more feasible to understand the impact of social marketing on innovative financing when it is deployed consistently in support of the global public-private partnerships such as Gavi, the Global Fund, the Global Partnership for Education (GPE), the Green Climate Fund (GCF), UNITAID and UNITLIFE.

4. Expansion across sectors

Getting innovative financing off the ground requires political leadership, willing champions and a well-defined value proposition of mechanism vis-à-vis the cause. All the mechanisms that form the classical canon of innovative financing for development to date have been in the health sector. The question of how innovative financing for development can be expanded to other sectors has been a preoccupation of development organisations and experts for some time. The recent extractive industries micro-levy to fight chronic malnutrition is the first innovative financing mechanism outside the health sector.

4.1. Chronic malnutrition and stunting

Political leadership, willing champions and a well-defined value proposition for the innovative financing revenue stream came together to make it possible to launch the extractive industries levy to fight chronic malnutrition through UNITLIFE.

One quarter of the world's children (over 160 million) under the age of five suffer from chronic malnutrition, and nutritional deficiencies underlie almost half of all deaths of under-fives. In Africa, chronic malnutrition remains the

leading risk factor for death and disability among children. We find high rates of stunting in countries that have considerable mineral wealth.

The economic costs of stunting to society, ranging from increased healthcare costs to loss of productivity, are significant. In low- and middle-income countries, a reduction of stunting by 20% would lead to an increase in GDP of over 3%. Even modest improvements in early childhood nutrition result in substantial economic 'uplift', with an increase in incomes of over 10%.[10] A US$100 package of interventions during the critical window of opportunity in the first 1,000 days (i.e. the pregnancy and the first two years of life) returns over US$3,000 in terms of positive economic impact and healthcare savings, including less educational failure, between two and three additional years spent in school, productivity gains of up to 45% as adults, between two and three times fewer illness episodes, and less complications in childbirth (such as low birth weight). It is estimated that to solve stunting in the 36 countries that have 90% of all stunted children worldwide, an annual investment of about US$10 billion per year is required.[11] Solutions include improved food security, maternal health and childcare interventions (including breastfeeding, adequate vitamins and minerals, and therapeutic feeding of malnourished children with special foods), adequate health services and a healthy environment.

4.2. Education

A number of prominent leaders and champions exist in the field of education, but this has not yet resulted in significant progress in innovative financing for education. Although education is one of the keys to sustainability and almost a billion children do not have adequate access to quality education, the specific attributes of education as an 'investment' sector for innovative financing revenues are complex. It is hard to replicate most of the health mechanisms in education because of the fundamentally different investment case for education.

There are essentially structural (and hence largely unchangeable) differences between these sectors that make the business case for innovative financing for education harder to formulate.[12] One of the main challenges in innovative financing for education is the difficulty in measuring the true social return of an investment, as the values inculcated by a good education system manifest themselves mainly in adulthood. The long lag between investment and outcome makes it difficult to identify the most cost-effective intervention. The long-term nature of education makes it harder, for example, to formulate an education bond similar to the vaccine bond based on the notion of 'frontloading' aid. Development impact bonds, which are securitised performance contracts, could be more useful to target specific goals in the education sector, for example in the education of girls.

The education sector is considered a 'government game'. Innovation in sustainable, equitable financing of education, especially for the poorest children

10 Hoddinott *et al.* (2013).
11 Horton (2010).
12 IFF (2013).

on our planet, is lagging behind as private education grows. More effective leverage between the growing private investments in education – mainly the result of under-performance of the public education system - and the public education system itself might be the best way forward. The Innovative Finance Foundation (IFF) put forward the idea of an education investment bank as a platform to provide leadership and inspiration, to support the panoply of players in the complex global education 'system' by raising funds, and to offer governments, aid agencies, philanthropy and private capital an opportunity for alignment, collaboration and leverage to lead to more and better educational investments. The Global Partnership for Education, the leading multilateral fund for basic education, might be able to take on such a role, but it will have to develop a broad view of its role and create the capacity required to engage in innovative financing for education.

Given that the cost of a child's education in developing countries is on average only US$150 a year, we should be able to put millions of children into quality schools with innovative financing, just like we managed to put millions of people around the world on life-saving treatments for AIDS, tuberculosis and malaria.

4.3. Climate change

The creation of the Green Climate Fund might provide the opportunity to inject into the relatively complex climate finance regime innovative financing mechanisms that can generate additional, sustainable and predictable funding. There appear to be limited opportunities to leverage the considerable private and public investment in climate safety such as energy efficiency and renewable energy, as these often benefit from subsidies and other preferential treatments.

The financial transactions tax scaled up to a global level is perhaps the most promising additional, predictable and sustainable innovative financing revenue stream in support of a global public good such as our common climate safety. An area that also might prove to be suitable for innovative financing in the context of climate change is the protection of the world's forests due to their function as carbon sinks.

In 2005, Parties to the United Nations Framework Convention on Climate Change (UNFCCC) agreed on a package of five activities in the forest sector, referred to as *Reducing Emissions from Deforestation and Forest Degradation* (REDD+). REDD+ essentially aims to incentivise developing countries to maintain their forest reserves by trying to assign a financial value to the carbon stored in forests, currently set in the absence of real markets at US$5 per tonne. However, there is ongoing discussion on how payments should be made and results monitored over time.

In addition to carbon storage, forests provide many other benefits to the earth's ecosystem and to people. The nature of these 'services' varies from place to place, and includes water regulation, soil protection, non-timber forest products (including food and fibre), climate regulation and biodiversity.

Innovative financing for development might not reach the scale of finance needed to combat climate change and protect forests, but with the financial

transaction tax and other global solidarity levies, it can be a way to leverage public-private partnerships such as the GCF as instruments of global finance for a global public good.

4.4. Endangered species

There is considerable political leadership provided by the Convention for the Protection of Endangered Species of Flora and Fauna (CITES) to undertake innovative financing in this space, built around track and trace technologies.

The last decades have seen spectacular advances in technological innovation, yet very little entrepreneurial activity has been focused on developing and diffusing technologies that can help combat illegal trade in wild flora and fauna and ensure that trade in endangered species is legal and sustainable. There are a range of technologies in optical recognition, sound recognition, laser imagery, satellite imagery, DNA analysis, data mining, scanning and analytics that could be used through investment in a track and trace approach.

The benefit case is clear: countries with substantial illegal trade in plants and animals can leapfrog ahead in environmental protection technologies. Customs officers, park rangers and conservation officers could be equipped with cutting edge systems and have better data and intelligence, with benefits for personal safety and improved professionalism.

CITES, the Innovative Finance Foundation and leading technology and security companies have formulated an approach to innovative financing for the protection of endangered species in the form of an Endangered Species Technology & Innovation Fund (ESTIF). The fund will contain trace and track technology applications, devices and services that can improve the control, regulation, and enforcement of international trade in endangered species, thereby helping to safeguard our planet's biodiversity. ESTIF will add value by delivering better science and better supply chain transparency, making legal trade more tightly controlled. This in turn will create more effective barriers to illegal trade.

A portion of the financial return from investment by leading technology companies in the dissemination to governmental and non-governmental organisations of their technologies will be donated to CITES for their vital work in the protection of endangered species. The application of such technologies would create jobs and income for local communities, thereby strengthening the sustainability of the approach.

5. Conclusion

Since the concept of innovative financing for development – mechanisms outside the traditional ambit of ODA that generate additional, sustainable and predictable revenues for development – was first introduced within the context of financing the MDGs, the term has been used widely to describe many types of initiatives. Most observers agree that innovative financing mechanisms are novel approaches that generate additional, sustainable and predictable revenues

for development and social infrastructure and are mainly channelled through global public-private partnerships.

To date, there have been only a handful of innovative financing mechanisms that conform to this definition and actually generate substantial additional, predictable and sustainable revenue streams for development and social infrastructure.

The health sector has been leading the way, with around US$8 billion in funding from innovative financing. The most important mechanisms are the air ticket levy channelled through UNITAID and the vaccine bonds supporting Gavi. Only very recently (in 2015) was the first innovative financing mechanism outside the health sector launched: the extractive industries micro-levy to fight chronic malnutrition. The levy is collected in a number of resource-rich African countries and is set individually by each country and each industry.

Getting innovative financing off the ground requires political leadership, willing champions and a well-defined value proposition of the funding for development and social infrastructure. In addition to the existing mechanisms in the health and nutrition sector, there are opportunities in education, climate safety and the protection of endangered species.

The role of the private sector in innovative financing is only just emerging. An untapped opportunity exists to work with the financial markets to ‘do good while investing well’. The deployment of attractive innovative finance offerings for the global financial markets, while no panacea for development financing, offers an opportunity to engage with a wider range of potential supporters and constructively contribute to the development of sustainable, robust, and long-term funding solutions for social infrastructure and development. The challenge is to formulate approaches and models that are capable of attracting a larger portion of assets into these sectors in a manner that is equitable and where the value proposition is well defined. There is also scope for the participation of business in improving the impact of existing innovative financing through win-win opportunities such as the Medicines Paten Pool. Pharmaceutical companies participating in the MPP make their patents for drugs available and are compensated by the pool, in effect putting in place a regulated regime for price reductions and the availability of the latest drugs in the poorest countries.

There can be no question that our global wealth can and must be tapped for the good of our planet – whether through solidarity levies, a financial transaction tax, social bonds or other financial innovations. Innovative financing for development lets everyone in the global economy participate, no matter where they live. The airline levy is an example of how to take advantage of the new globalised world and of how to make the world a better place by allowing all of us who are part of the global economy to make a positive contribution to our common welfare without putting holes in our pockets.

Innovative financing for development resonates with young people, perhaps because it hints at a world where development aid no longer plays a dominant role in relationships between countries, a world where every country can be a donor and a recipient, and a world where those who are global citizens in

a global economy share directly with those who are less fortunate. Innovative financing is solidarity.

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Financial Innovation for Global Solidarity

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Introduction

Two different, yet interrelated debates are currently taking place in international arenas. One is about the provision of global public goods, most notably climate change mitigation, under the auspices of the UNFCCC. The other relates to the adoption of the new post-2015 development agenda to succeed the MDGs, under the auspices of the UNGA. Both sets of debates pertain to the notion of 'global solidarity', defined as the collaborative pursuit of a global community of interests. This notion includes a 'within' dimension related to development challenges – such as poverty eradication, income distribution, education and health – and a 'global commons' dimension that calls for global collective action.

This chapter deals with innovative financing for global solidarity, and therefore cuts across both agendas. Much work has already been conducted on this issue in multilateral, regional and bilateral development institutions, as well as by various United Nations bodies and working groups.[1] Such work has been important in advancing understanding of the issue, and beyond the usual general statements about the need for a stable and well-regulated global financial system and a more coherent international financial architecture, it has converged around a few important ways to organise thinking as well as principles (UN System Task Team, 2013).

These include:

- increasing mobilisation and improving the allocation of (public and private, domestic and international) resources for sustainable development while providing a more effective framework for development cooperation;
- recognising that 'more than just money' is needed, notably through a toolkit of policy options, regulations, institutions, and (public and market-based) instruments to achieve better development outcomes; and
- reducing risk and lowering the cost of capital for investors within proper regulatory and institutional frameworks – in a nutshell, aligning private incentives with public goals (ICESDF, 2014).

1 See, for example, ICESDF (2014).

We do not repeat this analysis, on which we largely agree, in this chapter. Instead, we raise three issues that may not have received adequate attention and will be crucial elements of a dynamic approach to financing global solidarity.

First, we argue that global solidarity itself is dynamic and evolving as a result of an inherent tension between the traditional development agenda (poverty, education, health, etc.) and the global public goods agenda (climate change, environment, etc.) This tension arises due to the different perceptions among countries about priorities, and different views about the tradeoffs involved. The global solidarity agenda is therefore in constant evolution and rests on ongoing social interactions that take place in various ways in different parts of the world.

One proposal on the table summarises this agenda through 17 goals and 169 targets (Open Working Group, 2014), which shows how difficult it is to reach a global consensus on the concrete meaning of global solidarity. This suggests that what drives collective action is subject to a constant interaction between knowledge, evidence, advocacy, ideology, negotiation, discussion, tensions, and learning. This implies that the goal of financing global solidarity cannot be reduced to a list of items to finance, as it is in constant evolution and rests on the political economy of priority and agenda setting. For example, the goals and targets proposed by the Open Working Group may provide a collective framework for action, but priorities in implementing its recommendations will most likely be specific to nation states.

The second issue is about the very notion of 'financing', which should be thought of as a process of production in which financial resources are an input to produce 'global solidarity', but the 'production function' involves other inputs that are partly substitutable to finance and partly complementary, and the 'production technology' matters. In other words, 'financing' is not only, and not even fundamentally, about 'money'. Rather than 'how much', which of course cannot be ignored, the question of 'how' is much more important and should be at the core of the debate. However, the often inconclusive debate on the amount of financial resources that can be put on the table relegates the more fundamental debate on how to move ahead with action to a status of assumptions based on wishful thinking.

The third issue has already received much attention through the notion of 'blending'. We argue here that instead of being relegated to a sort of 'cherry on the cake' that opens new frontiers (and often finds itself an 'add-on' to the discussion on finance), 'blending', or new innovative approaches to finance that bring together public and private actors, is absolutely central to the pursuit of both individual as well as collective interests. We see it as a very powerful approach to the question of 'how' mentioned above, because it has the potential to reset incentives for the various actors.

1. Tension between the traditional development challenges and the global public goods agenda

The relationship between the traditional development agenda (poverty eradication, education, health, etc.) and the agenda related to the provision of global public goods (most notably with regards to climate change) is a complex one. Some argue that the two are intrinsically aligned, and others believe they are not always compatible. This debate has strong political overtones that colour individual positions. To the extent that the provision of global public goods requires efforts and resources and that, in many instances, it amounts to taking corrective measures to mitigate the impact of the actions of rich countries, many developing countries make their participation in the collective exercise conditional on both actions by developed countries and financial compensation.

Over the long term, and in a world with perfect knowledge, there is little doubt that the two agendas are logically and inherently consistent. It would not make sense to promote 'unsustainable' development, to finance development programmes that neither take climate change into account nor facilitate adaptation, or to continue deteriorating global commons. Conversely, the provision of global public goods is hardly compatible with the persistence of extreme poverty. In practice, however, the agendas do not appear to be aligned for at least two reasons.

First, there is scientific and practical uncertainty over the global public goods and sustainability agendas. There are many things we still don't know, whether about climate change (such as the detailed nature and distribution of its impacts, or the cost-effectiveness of various mitigation and adaptation interventions) or other global public goods. Such uncertainty does not imply that we should not feature them highly on the policy agenda, but it does mean that building a consensus for action is problematic, as the evidence will always tend to be contested. It is difficult to align the two agendas given these uncertainties. The global agenda, therefore, evolves out of advocacy and lobbying between various views, convictions and interest groups, each of which may claim to represent the common interest. As a result of this uncertainty, action often takes place when actual and perceived damages have made it clear that a current situation is unsustainable – rather than acting for sustainability, it is easier to react to unsustainability. Unfortunately, the perception of unsustainability is stronger after, rather than before, crises and catastrophes. Shifting the global public goods and sustainability agendas from a crisis management approach to a prevention approach is thus at the core of current debates. What this implies is that, *de facto*, these agendas cannot be pre-set in any deterministic way, but must evolve in a dynamic action-reaction framework. Current actions produce unsustainable outcomes such as catastrophes and other crises that call for reaction, and the process goes on. Some will argue that this model of *ex post* reaction eventually works, but there are two major drawbacks: crises may be very costly, and irreversible changes may take place that cannot be corrected.

Second, from a political economy perspective, the time horizons of the two agendas differ. For example, developing countries may want to prioritise the

traditional development goals (which emphasise immediate 'material' gains through economic growth, poverty eradication, and the provision of education and healthcare) over global public goods like sustainability and climate change mitigation (which many refer to as 'post-materialist' concerns).[2] Any proposed change in the production and distribution of material gains as a result of the provision of global public goods could well be interpreted as an (unaffordable) net cost unless it directly or visibly contributes to greater immediate effectiveness or higher real income (through energy savings, for example).

The two agendas therefore do not naturally converge and the broader post-2015 agenda, which comprises both the traditional development agenda and the global public goods agenda, is constantly evolving, with varying sets of priorities. This is also one of the reasons why the United Nations' Open Working Group (2014) needed 17 goals and 169 targets to reach an agreement. Financing global solidarity therefore intrinsically implies addressing some of the tensions that affect individual as well as collective action, which suggests that the amount of money available cannot be the only determinant.

2. Finance is much more than just 'money'

Substantial analytical work has also been conducted on financing the sustainable development agenda. This work, which we will not review here, is a useful guide to identifying concrete actions and thinking about how they can be financed. Our contention is that there is a need to address more deeply the question of 'how': How are the actions that have been identified going to be undertaken? Costing exercises assume that (i) there is a clearly identified unique set of actions, and (ii) the actions can be implemented successfully. Under these assumptions, they provide information about the amount of financial resources needed to achieve their objectives. But these assumptions may not always hold.

First, even if the costs of different desired actions could be adequately estimated and even if the proper funding commitments could be gathered, it does not necessarily follow that the desired actions will take place. They may be inhibited by several other (non-financial) obstacles – some of which we discuss below – as well as political economy considerations that go far deeper than technical costing and funding exercises. The availability of financial resources may indeed act as a facilitator, but most of the time will be insufficient to address the obstacles, and may even be dependent on how these obstacles can be addressed. Our contention is thus that the availability of needed financial resources is as much the result of a set of policy decisions as an engine for proper decision-making.

Second, costs depend on behaviours and policies. It thus may not be possible to properly estimate the costs of reaching a particular objective. A simple example illustrates this: suppose that an industrial company pollutes a river with chemical waste. One option may be to restore 'sustainability' by cleaning the river regularly (assuming there is a technical solution for this), and to estimate the recurrent costs of doing so at given intervals. Another option, which many

2 Pritchett (2014).

would deem superior, is to change the incentives facing the polluting firm (through tax or regulation, or through pressure from civil society organisations) so that it 'internalises' the cost of polluting and decides to change its production technology to limit pollution. There will be a cost to the firm, and a broader social cost of implementing the tax or regulation. The true costing will depend on which option is chosen.

Hence, we argue that the very notion of 'financing' should be thought of as a process of production in which financial resources are one input, but the 'production function' involves other inputs that are partly substitutable with finance and partly complementary, and where the production technology matters.

This is recognised in existing reports. ICESDF (2014), for example, notes that while the needs are huge and challenges enormous, they are surmountable because global public and private savings are sufficient. But it also notes that current patterns of finance are not adapted to these needs and challenges – most notably because expected returns on investments associated with sustainable development are not as attractive as other opportunities, especially in the near term – and that there are many competing demands on public resources, which confirms that the availability of resources cannot be a sufficient condition to move forward.

Having said all of this, there are, in our view, a series of 'no-regret' financial investments the international community must consider.

The first is significantly increasing the resources devoted to scientific research on (environmental and social) sustainability issues. This would not only promote the generation of scientific knowledge, but also generate new incentives to work on sustainability. The examples of global scientific initiatives in the past – such as the CGIAR model in agriculture, which led to the first Green Revolution, and the Intergovernmental Panel on Climate Change – demonstrate to us that this is doable and a worthwhile investment.

The second is identifying, documenting and promoting 'win-win' opportunities – for example, investments in energy efficiency that reduce costs and promote sustainability at the same time. But, as some free-marketers would argue, if these 'win-win' opportunities are not being exploited on their own, why must they be catalysed through conscious facilitative investments and actions? There are several reasons why such win-win situations may exist but are ignored. First, there may be an information problem, which could be related to a lack of technical knowledge, or a lack of information on market opportunities in certain parts of the world. Second, there may be a risk problem that holds back private investors from committing financial resources. Third, there may be a policy or regulatory problem, with local policies either creating barriers to investments or trade that impede potential profitability, or providing subsidies that prevent innovation by sustaining current practices and distorting markets (for example, fossil fuel subsidies). More research is needed within developing countries to identify such 'win-win' opportunities and to disseminate them.

The third 'no-regret' investment is in evidence-based advocacy campaigns to raise citizens' awareness and sense of responsibility towards future generations,

and sustainability issues in particular. It is thanks to sustained mobilisation of citizens over the last two decades (partly facilitated by increased financial resources to support advocacy) that the sustainable development debate has now entered the highest political arenas as one of the top international priorities. A concrete example of this is the Post-2015 Consensus Project launched by the Copenhagen Consensus Center,[3] which is undertaking a cost-benefit analysis of the various proposed targets in the post-2015 agenda through a peer-review process and disseminating the findings to governments and the general public. Many such initiatives are underway and must be invested in.

Even more is needed in terms of knowledge creation and dissemination. The next steps might be to relate as much as possible the available evidence to the analysis of costs to society. On social issues, while there is a global consensus on fighting poverty and reducing inequality, or on promoting 'inclusive growth', the identification of concrete actions to undertake is constrained by the limited knowledge of people's livelihoods across the world. More locally based knowledge generation is therefore critical.[4] Financial resources should be further mobilised to promote concrete and empirical research into how global public good concerns interact with local citizen's welfare and livelihoods.

3. Putting blended finance at the core of financial innovation

Our main message from the previous sections is that the crucial question to answer is not actually 'what' to finance or 'how much' resources to provide, but 'how' to use scarce financial resources to change incentives. This important question brings to centre-stage financial instruments and financial innovation, as opposed to the quantity of financial resources that can be made available. By 'innovation' we do not necessarily mean sophisticated technical innovations such as those that have characterised financial markets in the recent decades. Instead, we mainly mean simple combinations of standard financial instruments, such as loans, grants and guarantees that are appropriately structured and targeted to development finance.

Our central argument is that 'blended finance' (defined as the deliberate and organised pooling of public and private resources and expertise) is fundamental to the finance agenda. The reason for this conviction is that the other more 'traditional' types of finance emphasised in the ICESDF (2014) report – namely, the mobilisation of public and private, domestic and international resources – do not adequately address the central political economy problem of sustainable development. Through the traditional channels, we may in theory raise billions of dollars, but may still be unable to invest them appropriately. Any discussion on traditional channels is mainly centred on the quantity of finance available, not the incentive structure (or production function) that transforms finance into

3 For information on the project, see http://www.copenhagenconsensus.com/post-2015-consensus/background.

4 Promoting locally generated academic knowledge, which can be mobilised for such purposes, is the major *raison d'être* of the Global Development Network (GDN).

action and results. Moreover, the mobilisation of resources itself depends on that incentive structure.

We therefore suggest that blended finance should be far more central to the finance discussions, and indeed should be the starting point for many discussions. And this is where the main potential of 'innovative finance' lies. In that sense, the sustainable development agenda is indeed one of financial innovation.

ICESDF recognises the potential of blended finance. However, it comes at the end of their well-documented report as something to further explore, as opposed to being one of the central recommendations to act on. The report describes the major blended finance instruments, from direct financing of the private sector, to blended risk-based or performance-based instruments, to elaborate public-private partnerships (Table 1, p. 39). This is a useful framework and we now need to build on it.

We believe that 'blending' can help realign incentives in two major ways:

- it can help reconcile private interests with the pursuit of global and local public goods; and
- it can help bring much more focus on performance and results.

This is indeed a 'public-private partnership' agenda, not in the sense of any case-by-case contractual arrangement between a public entity and a private contractor, but more fundamentally as a way to engage private actors in the provision of public goods. Such engagement requires both a focus on the public goods dimensions and social impact of private investments (which may not come naturally to private investors) and due consideration to private profitability, thus gearing private investments towards producing public goods.

However, there are technical, legal and contractual, as well as cultural challenges to this agenda. Technical challenges are the simplest to address. Current innovations suggest that there is indeed a high potential for finding productive ways to blend public and private resources. A number of risk-sharing instruments are already in use through which public money is used to mitigate risks (beyond market risks) that the private sector will not be willing to take. Such risks may be due to lack of information, weather uncertainty, political instability or intrinsic vulnerability, for example. The risk-mitigation agenda does not stop at public-private partnerships, though. In many cases, it is interesting to combine risk-mitigation instruments with conventional public finance. For example, development loans might include more systematically provisions that protect the debtor in case of unfavourable evolution of the market environment.[5] 'Concessionality' may thus be increasingly developed as a 'blending' instrument. Instead of focusing on the degree of concessionality from a charity perspective, it would be advisable to ask what is obtained as an outcome of the concessionality. If the investment that is financed through the loan turns out to be profitable, there is no need for concessionality *ex ante*. However, if it turns out to be less profitable than the cost of the loan for reasons other than poor management, there is a case

5 The French Development Agency introduced in the mid-2000s a 'contra-cyclical concessional loan', which allowed the debtor country to suspend debt service in case of a negative shock.

for at least some form of risk-sharing and donor compensation. The notion of 'concessionality' may thus usefully evolve from a traditional view of a monetary 'subsidy' to that of a 'risk-sharing' mechanism through which a private investor can be compensated if certain types of risk arise during project execution. This debate is just starting and faces considerable ideological obstacles.

The deeper obstacles relate to the prejudice against private actors. Since they are pursuing private profitability, a common assumption is that private actors cannot promote the public interest. This 'private versus public' view is a major impediment to innovative thinking. Trust needs to be rebuilt here, as there are several examples of 'public-private partnerships' of various kinds failing in the past either due to poorly designed and enforced contracts, or for other reasons. This prejudice cannot be changed without the full cooperation of both sides: from the public side, a better understanding of the functioning of private companies; from the private side, a higher consideration for the ultimate social objectives of economic activity. It is encouraging that, through forums such as the World Economic Forum, the idea of a structured public-private approach and partnerships is gradually taking hold, with major private companies willing to take the lead.[6]

Notwithstanding these prejudices, interesting innovations are taking place in development finance.

In the 2000s, a first innovation came with the notion of outcome-based aid, namely, an aid instrument that is designed to disburse public money as a counterpart to actual results. Several instruments have since built on that notion.

The World Bank (2013), for example, talks of 'pull-based mechanisms' which provide *ex post* economic incentives to reward specific innovations that solve a well-defined development problem. By linking payments to the actual impact of an innovation, these mechanisms can help create a self-sustaining, competitive market for the relevant product. For example, in 'advance market commitments', instead of financing private research and development, public money is used to guarantee market demand once private R&D has produced a desired innovation. The World Bank (2013) refers to the AgResults Initiative, a new pull mechanism developed by Australia, Canada, the UK and the US – working in partnership with the Bill & Melinda Gates Foundation, the World Bank and Dalberg, a global development advisory firm – which uses public financing to reward agricultural innovation in developing countries and, in the process, build sustainable markets for agricultural inputs, products and services that benefit the poor, while pulling in private investment and technological innovation.

Carbon markets, through cap-and-trade schemes, provide another source of innovative finance. Recently, 73 countries and 11 states and provinces – together responsible for 54% of global GHG emissions and 52% of GDP – joined 11 cities and over 1,000 businesses and investors in signalling their support for

6 A one-day workshop took place in New York on 24 July 2014, organised by the World Economic Forum at the request of the United Nations, to discuss the role of the private sector in the sustainable development agenda.

carbon pricing, which suggests that this instrument might be at the cusp of a major take-off.[7]

Similarly, some countries have experimented with the concept of 'resource for infrastructure deals' (mainly in fragile states), whereby mineral extraction rights are exchanged for turnkey infrastructure development to overcome obstacles related to limited domestic capital markets and implementation capacity (although this mechanism has its own challenges in implementation).[8]

Concepts like 'results-based financing' are also gathering great momentum. In 2012, the World Bank has pioneered an instrument called Program-for-Results (PforR) Financing[9] that directly finances development activities, disbursing against achievement of programme results rather than against inputs. Started in 2012, the initial results have been promising and the Bank is keen to scale up the programme. The Japanese International Cooperation Agency (JICA) has also been making results-based loans to countries such as Nigeria and Pakistan for health projects, incorporating an innovative 'loan conversion' mechanism through which the Bill & Melinda Gates Foundation will pay back the debt service to JICA in place of the national governments if the project successfully achieves the performance trigger indicators during implementation.[10] Social impact bonds aim to do the same for service delivery – here, private investors pay the upfront costs for providing social services and government agencies repay the investors with a return, but only if a third-party evaluator determines that the services achieve agreed-upon outcomes.[11]

These are promising approaches in that they can create powerful incentives to manage projects properly and improve governance. One might also design market-based instruments (loans) in which there is an element of subsidisation in case of a negative shock, as briefly discussed above.

All this points to the agenda of reforming official development assistance (ODA). Unfortunately, the debate remains politically mired in a quantitative approach (reaching the mythical 0.7% of GDP), which does make much sense given the arbitrary measurement of what is referred to as ODA. We probably do need quantitative targets, but the current definition of ODA hardly captures what is needed. The only quantitative notion that really makes sense (and is much simpler than the complex calculations based on hypothetical discount rates that characterise the current statistical definition of aid) is the actual budgetary effort made by donor governments for development assistance. One of the keys to financial innovation is to disconnect the public grant element from the actual financing of development. Instead of talking about concessional loans,

7 See the recent announcement at http://www.worldbank.org/en/news/feature/2014/09/22/governments-businesses-support-carbon-pricing.

8 World Bank (2013).

9 For a review of the PforR approach, see http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/0,,contentMDK:23215867~pagePK:41367~piPK:51533~theSitePK:40941,00.html.

10 Read more at http://www.jica.go.jp/usa/english/office/others/newsletter/2014/1405_06_03.html and here: http://www.gatesfoundation.org/Media-Center/Press-Releases/2011/08/JICA-and-the-Foundation-Announce-Partnership-on-Polio-Eradication.

11 These have not really taken off at scale in developing countries yet.

for example, and being obsessed by the degree of concessionality, it is more productive to ask why a given development project could not be financed through a market loan and to consider that any subsidy element should be designed to address these reasons, which might range from the insufficient immediate profitability of social investments, to various kinds of risks, to a lack of solvency of targeted markets. Public subsidies can thus be blended into many kinds of financial instruments, such as loans, equity, full grants and guarantees. Each of these may benefit from some elements of subsidisation. The calculation of the 'degree of concessionality', which still animates the statistical collection of ODA, is a waste of time and energy and harms the political debate, because it focuses on a vision of 'generosity' that is misplaced. What matters is why the instrument is subsidised and to what end. Is it to mitigate risks, to incentivise results and proper management, or to mobilise other resources, perhaps? This is a very promising agenda for ODA and it is encouraging that, even though the focus remains on concessionality and the overall quantitative commitment, the donor community now recognises the need to think of ODA more as a catalyst than as a stand-alone financing scheme.[12]

4. Concluding remarks

Our main message in this chapter is that the sustainable development agenda is a problem of collective action, and the success of global solidarity rests in the alignment of the objectives and interests of the various stakeholders. It is our view that blended finance and financial innovation, as defined above, can play a central role in achieving this alignment, particularly in analysing how public and private resources and expertise can best be blended. This agenda is just starting off and deserves a major boost. It should be recognised as a defining element of the post-2015 agenda, should be the subject of much more attention and debate, and should be a major area of experimentation and evaluation.

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